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The Merger and Acquisition Provisions of the ALI Corporate Governance Project as Applied to the Three Steps in the Time-Warner Acquisition

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THE MERGER AND ACQUISITION PROVISIONS OF THE ALI CORPORATE GOVERNANCE PROJECT AS APPLIED TO THE THREE STEPS IN THE TIME-WARNER ACQUISITION

Samuel C. Thompson, Jr.*

TABLE OF CONTENTS

I.	INTRODUCTION	150
A.	In General	150
B.	Use of the Time-Warner Transaction	151
C.	Structure of Article	153
1.	Duty of Care and Business Judgment Rule . . .	153
2.	Arm's Length Mergers and Acquisitions	153
3.	Management Buyouts	155
4.	Defensive Tactics in Tender Offers	155
5.	Sale of Controlling Stock Interests	155
6.	Freezeout Transactions	156
7.	Summary of Structure	156
II.	DUTY OF CARE AND BUSINESS JUDGMENT RULE . . .	157
A.	Introduction	157
B.	Duty of Care	158
C.	Business Judgment Rule	159
D.	Illustration of Application of the Business Judgment Rule to an Acquiring Corporation	165
E.	Observations	166

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III. ARM'S LENGTH MERGERS AND ACQUISITIONS	169
A. Introduction to Section 6.01	169
B. Definition of Transaction in Control	169
C. General Impact of Shareholder Vote Requirement Under Section 6.01(b)	172
D. General Impact of Director Action Requirement Under Section 6.01(a): The Business Judgment Rule	176
1. Basic Concepts	176
2. Duty to Inform	178
3. Disclosure and Approval Negate Personal Liability	180
4. Action in Good Faith and Absence of Interest .	181
5. Rational Belief that Action is in Best Interest of the Corporation	181
E. Illustration of Operation of Section 6.01	181
F. The General Appraisal Remedy	183
1. Introduction	183
2. Transactions in Control Giving Rise to Appraisal Rights	184
3. General Procedural Requirements	188
4. Standards for Determining Fair Value	189
a. In General	189
b. Fair Value in Arm's Length Transactions . .	190
5. Exclusivity of Appraisal Remedy	191
a. In General	191
b. Exclusivity of Appraisal Proceedings for Arm's Length Mergers and Acquisitions . . .	192
G. Application to the Time-Warner Transaction of the Delaware and ALI Arm's Length Merger Rules Regarding Director Action and Shareholder Voting and Appraisal Rights	193
1. Description of the Originally Proposed Time-Warner Merger	193
2. Required Actions and Standards Governing Actions of Time's and Warner's Boards of Directors . .	196
a. Time's Board	196
b. Warner's Board	197
3. The Right of Shareholders to Vote	198
a. Time's Shareholders	198
b. Warner's Shareholders	199
4. Right of Shareholders to Appraisal	200

5.	Right to Appraisal in Originally Proposed Merger	200
a.	Time's Shareholders	200
b.	Warner's Shareholders	201
6.	Exclusivity of Appraisal Proceedings in Originally Proposed Merger	202
a.	Time's Shareholders	202
b.	Warner's Shareholders	204
7.	Determining Fair Value of Shares in Originally Proposed Merger	204
H.	Observations	205
IV.	MANAGEMENT BUYOUTS	206
A.	Introduction	206
B.	The Disclosure and Market Review Requirements of Section 5.15(b)	210
C.	Appraisal Rights in Management Buyouts	214
1.	Management Buyouts as Transactions in Control Giving Rise to Appraisal Rights	214
2.	Determining Fair Value in Interested Party Transactions Like MBOs	216
3.	Non-Exclusivity of Appraisal Proceedings for Management Buyouts	218
D.	Application of the ALI MBO Rules of Section 5.15 and Related Appraisal Rules to the Time-Warner Transaction	219
1.	The Section 5.15 MBO Rules	219
2.	Right of Appraisal if Originally Proposed Merger were Tested as a MBO Under Section 5.15	222
3.	Exclusivity of Appraisal Proceedings if Originally Proposed Merger were Treated as a MBO Under Section 5.15	222
4.	Determining Fair Value of Shares in Appraisal Proceeding if Originally Proposed Merger were Treated as a MBO Under Section 5.15	223
E.	Observation	224
V.	ACTION BY TARGET'S DIRECTORS THAT HAS THE FORESEEABLE EFFECT OF BLOCKING AN UNSOLICITED TENDER OFFER	224
A.	In General	224
B.	Rejection of <i>Unocal's</i> Allocation of the	

Burden of Proof	227
C. Effect on Control Share, Business Combination and Similar Statutes	228
D. Comparison of the Section 6.02 Standard with the Business Judgment Rule	229
E. General Scope of Defensive Actions	230
F. Self-Tenders	231
G. Reaction to Coercive Two-Tier Offers	231
H. Redemption of Poison Pills	232
I. Effect of the <i>Time</i> Decision and the "Just Say No" Defense	233
J. Application of the Delaware and ALI Defensive Tactics Rules to the Time-Warner Transaction . . .	236
1. Description of Paramount's Tender Offer for Time and Time's Responsive Tender Offer for Warner	236
2. Standards Governing Actions by Boards of Directors	238
a. Paramount's Board	238
b. Time's Board	238
c. Warner's Board	240
3. Shareholders Voting	240
4. Appraisal Rights in Paramount's Tender Offer for Time and in Time's Tender Offer for Warner . .	241
a. Time's and Paramount's Shareholders as Acquiror Shareholders	241
b. Warner's Shareholders	242
K. Observations	242
VI. SALE BY CONTROLLING SHAREHOLDERS OF STOCK OF TARGET TO THIRD PARTY	243
A. The Rules	243
B. Application of the Delaware and ALI Sale of Controlling Shares Rules to the Time-Warner Transaction	246
1. How a Hypothetical Sale of Controlling Shares Could Have Been Implicated	246
2. Treatment of a Hypothetical Sale of Controlling Shares of Warner to Time Prior to Tender Offer	246
C. Observations	247

VII. NON-MAJORITY CONTROL AND MAJORITY CONTROL

FREEZEOUTS	247
A. Introduction	247
B. Non-Majority Control Freezeouts	249
1. Introduction	249
2. No Disclosure Needed Before Transaction Subject to Fairness Standard	252
3. Proof of Fairness	252
4. Appraisal Rights in Non-Majority Control Freezeouts	254
a. Availability of Appraisal Rights	254
b. Determining Fair Value in a Non-Majority Control Freezeout	254
(1) In General	254
(2) Determining Fair Value in Two-Tier Offers	254
c. Non-Exclusivity of Appraisal Proceeding for Non-Majority Control Freezeouts	255
C. Majority Control Freezeouts	257
1. Introduction	257
2. Appraisal Rights in Majority Control Freezeouts	257
a. Availability of Appraisal Rights	257
b. Determining Fair Value in a Majority Controlled Freezeout	258
c. Exclusivity of Appraisal Proceedings for Certain Majority Control Freezeouts	258
(1) In General	258
(2) Reasonable Belief of Directors as to Fair Value	261
(3) Disclosure Requirement	262
(4) Two Step Transactions	263
(5) Illustrations	264
3. Existing Law	265
D. Application of the Delaware and ALI Freezeout Rules to the Time-Warner Transaction	268
1. Description of the Freezeout Transaction	268
2. Required Actions and Standards Governing the Actions of the Boards of Directors	270
a. Time's Board	270
b. Warner's Board	271
3. Right of Shareholders to Vote	272
a. Time's Shareholders	272
b. Warner's Shareholders	273

4.	Appraisal Rights in the Second Step Freezeout Transaction	273
a.	Time's Shareholders	273
b.	Warner's Shareholders	274
5.	Exclusivity of Appraisal Proceedings for Warner's Shareholders in the Second Step Freezeout Transaction	274
6.	Determining Fair Value of Shares in Appraisal Proceeding in the Second Step Freezeout Transaction	276
E.	Observations	277
VIII.	CONCLUSION	279

I. INTRODUCTION

A. In General

In March 1994, The American Law Institute published its *Principles of Corporate Governance: Analysis and Recommendations* ("ALI Corporate Governance Project" or "Project").¹ This Project encompasses numerous aspects of corporate law affecting the general management of "substantial enterprises,"² including the functions and powers of directors and officers; the duty of care; the business judgment rule; the duty of fair dealing; defensive tactics in tender offers; and remedies, such as derivative actions and appraisal proceedings.

This article examines the provisions of this Project that have an impact on various forms of mergers and acquisitions, which for this purpose include all forms of business combinations, tender offers, freezeouts and sales of controlling stock interests. Thus, the mergers and acquisitions addressed here encompass

¹ AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS (1994) [hereinafter ALI CORPORATE GOVERNANCE PROJECT]. See generally *Symposium on Corporate Governance*, 48 BUS. LAW. 1267-1483 (1993); *Symposium: the American Law Institute's Principles of Corporate Governance*, 61 GEO. WASH. L. REV. 871-1293 (1993). See also Roswell B. Perkins, *The ALI Corporate Governance Project in Midstream*, 41 BUS. LAW. 1195 (1986); Roswell B. Perkins, *The Geneses and Goals of the ALI Corporate Governance Project*, 8 CARDOZO L. REV. 661 (1987).

² 1 ALI CORPORATE GOVERNANCE PROJECT, *supra* note 1, at ix.

transactions that the *Project* refers to as “transaction[s] in control,” and all other forms of acquisitions addressed in the *Project*. The concept of a “transaction in control” is explored in Section III.B.

The *Project* sets out different governance rules for the following types of mergers and acquisitions:

- (1) Transactions in control, other than management buyouts (hereinafter arm’s length mergers and acquisitions);
- (2) Management buyouts;
- (3) Defensive tactics in tender offers;
- (4) Sale of controlling stock interests; and
- (5) Freezeouts.

B. Use of the Time-Warner Transaction

Each of the merger and acquisition governance rules in the *Project* either would have applied in Time, Inc.’s 1989 acquisition of Warner Communications, Inc. or can be illustrated by reference to that acquisition. Therefore, this article uses the facts of the Time-Warner transaction to illustrate the operation of these governance rules and to compare the effect of these rules to the results that actually applied in the Time-Warner transaction under Delaware law. Also, relevant developments in Delaware law since Time-Warner are examined, including the Delaware Supreme Court’s decision in *Cinerama, Inc. v. Technicolor, Inc.*,³ *Paramount Communications, Inc. v. QVC Network, Inc.*,⁴ and *Arnold v. Society for Savings Bancorp, Inc.*⁵

The Time-Warner acquisition involved three basic transactions. First, Time and Warner entered into a merger agreement pursuant to which Time was to acquire Warner in exchange for stock of Time. The transaction included a lock-up stock option agreement pursuant to which Time and Warner had options to purchase a block of each other’s stock in the event the merger was not completed. The purpose of this stock option agreement was to discourage other firms from attempting to acquire either Time or Warner.

³ 1995 WL 431434 (Del. 1995).

⁴ 637 A.2d 34 (Del. 1993).

⁵ 650 A.2d 1270 (Del. 1994).

This merger transaction would be a transaction in control under the *Project* and would be subject to the *Project's* governance rules for arm's length mergers and similar transactions. Because of the structure of the Time-Warner transaction, it would appear that the *Project's* management buyout provisions could also have been implicated in the merger. Apparently, the drafters of the *Project* did not contemplate this effect.

The original structure of the merger was abandoned by Time after Paramount made an unwanted tender offer for Time. Time responded by restructuring the merger with Warner into a tender offer by Time for Warner. Thus, the second phase of the Time-Warner transaction involved a tender offer by Paramount for Time and a responding tender offer by Time for Warner.

Paramount, not wanting to acquire both Time and Warner, amended its tender offer and conditioned the closing on, inter alia, the termination of Time's tender offer for Warner and the redemption or invalidation of Time's poison pill. Thus, Time's action implicates the *Project's* governance rules on defensive tactics in tender offers. These rules can be compared with the Delaware Supreme Court's decision in *Paramount Communications, Inc. v. Time, Inc. (Time-Warner)*⁶ which dealt explicitly with Time's defensive actions. The court found Time's actions to be consistent with the requirements of *Unocal Corp. v. Mesa Petroleum Co.*,⁷ which applies an enhanced business judgment rule to directors' defensive actions. This standard requires directors to establish that they had reasonable grounds for believing that there was a danger to corporate policy and effectiveness and that the defensive actions taken were reasonable in relation to the threat posed. As a result of the *Time-Warner* decision, Paramount abandoned its tender offer for Time, and Time completed its tender offer for approximately 60% of the stock of Warner.

Although Time's tender offer for Warner was not preceded by a purchase by Time of a controlling stock interest in Warner, such a transaction sometimes precedes a tender offer. If Time had made such a purchase, the provisions of the *Project* dealing with sales of controlling stock interests would have been applicable. Thus, a slight hypothetical modification of this part of

⁶ 571 A.2d 1140 (Del. 1989).

⁷ 493 A.2d 946 (Del. 1985).

the Time-Warner transaction can be used to illustrate the *Project's* governance rules regarding sales of controlling stock interests.

The third aspect of the Time-Warner transaction involved a freezeout merger which occurred after the completion of Time's tender offer for Warner. This freezeout involved a reverse subsidiary merger, pursuant to which Time acquired the remaining 40% of Warner shares held by the public. The freezeout provisions of the *Project* would apply to this type of transaction.

Thus, the three steps in the Time-Warner transaction (i.e., the originally structured arm's length merger; the tender offer by Paramount for Time and Time's responding tender offer for Warner; and the second step freezeout merger) can be used to illustrate the application of each of the merger and acquisition provisions of the *ALI Corporate Governance Project* and to compare the results under the *Project* to those that arose under Delaware law.

C. Structure of Article

This article proceeds as follows:

1. Duty of Care and Business Judgment Rule

The first topic considered here is the duty of care of directors and officers and the related business judgment rule.⁸ These concepts, which are fundamental to corporate governance and are applicable in many of the specific rules of the *Project* governing mergers and acquisitions, are addressed in Section 4.01 of the *Project*. Thus, Section 4.01 sets out the general rules governing the management of the corporation by the directors and officers. These principles generally apply when a target corporation engages in a transaction in control. They also apply to the directors and officers of an acquiring corporation.

2. Arm's Length Mergers and Acquisitions

The second topic addressed herein is the role of the directors and shareholders with respect to transactions in control, other

⁸ See *infra* Part II.

than management buyouts, proposed to a corporation.⁹ This topic is addressed in Section 6.01 of the *Project*. Also, the related rules regarding appraisals are considered.

Section 6.01 encompasses all forms of consensual mergers and acquisitions in which the stock or assets of an independent target corporation are being acquired by an acquiring corporation in an arm's length transaction. Section 6.01(a) provides that the duty of care and business judgment rule set forth in Section 4.01 apply to the actions of directors in transactions governed by Section 6.01. Section 6.01(b) governs the voting rights of the shareholders of the parties to a transaction in control.

In a transaction in control governed by Section 6.01 of the *Project*, Section 7.21 provides that the target corporation's shareholders have appraisal rights. These rights give a shareholder who votes against a transaction the right to elect to have the value of his or her shares determined by an appraisal court. In such case, in lieu of receiving the consideration specified in the merger or acquisition, the electing shareholder receives a cash payment for the shares in the amount of the value determined by the appraisal court.

Also, the acquiring corporation's shareholders have this appraisal right unless they own at least 60% of the stock of the acquiring corporation after the transaction. Thus, in the garden variety arm's length merger or acquisition in which a large acquiring corporation acquires the stock or assets of a small target, only the shareholders of the target have appraisal rights. Such appraisal rights are not granted, however, in a sale of substantial assets of the target that leaves it without a significant continuing business if such sale is for cash or cash equivalents and the target makes liquidating distributions within one year of the sale.¹⁰

Section 7.24 provides that if certain conditions are met, an appraisal proceeding is the shareholder's exclusive remedy for challenging a transaction under Section 6.01.

Section III.G of this article looks at the impact of Delaware law and the *Project's* governance rules in the originally proposed Time-Warner merger transaction.

⁹ See *infra* Part III.

¹⁰ 2 ALI CORPORATE GOVERNANCE PROJECT, *supra* note 1, § 7.21(c)(2).

3. Management Buyouts

The third provision of the *Project* examined here is Section 5.15, which governs a transfer of control in which a director or senior executive officer of the target is interested.¹¹ Thus, this type of transaction encompasses management buyouts in which the management of the target ends up with a significant equity position in the surviving corporation after the change in control of the target. Transactions under Section 5.15 may give rise to appraisal rights under Section 7.21; however, appraisal is not the exclusive remedy as is provided in Section 7.24 for arm's length mergers and acquisitions.

Section IV.C considers the potential impact of Section 5.15 on the originally proposed Time-Warner merger.

4. Defensive Tactics in Tender Offers

The fourth topic considered is Section 6.02 of the *Project*, which deals with actions of a target's directors that have the foreseeable effect of blocking an unsolicited tender offer.¹² Thus, this provision governs the actions of the target's directors in attempting to defend against a hostile tender offer. The appraisal remedy is not involved here.

Section V.J examines the impact of Section 6.02 and Delaware law on the defensive actions taken by Time's directors.

5. Sale of Controlling Stock Interests

The fifth topic considered here is the disposition by the controlling shareholder of its shares to a third party.¹³ Section 5.16 of the *Project* addresses this issue. No appraisal rights attach in these transactions.

Section VI.B examines the impact of Section 5.16 and Delaware law on a hypothetical pre-merger sale of a controlling stock interest in the Time-Warner transaction.

¹¹ See *infra* Part IV.

¹² See *infra* Part V.

¹³ See *infra* Part VI.

6. Freezeout Transactions

The sixth topic considered here is a freezeout transaction, in which a controlling shareholder forces the minority shareholders to sell their shares, with the controlling shareholder becoming the sole shareholder.¹⁴ The *Project* divides freezeouts into two types of transactions.

First, those transactions in which the controlling shareholder does not have sufficient voting power to unilaterally effectuate the freezeout. These transactions are referred to here as "non-majority control freezeouts."

Second, those transactions in which the controlling shareholder possesses sufficient voting power to unilaterally effectuate the transaction, as is the case with short form mergers. These transactions are referred to here as "majority control freezeouts."

Both types of freezeouts, are governed by Section 5.10. In majority control freezeouts, if the conditions of Section 7.25 are satisfied, appraisal is the exclusive remedy; however, appraisal is not the exclusive remedy in a non-majority control freezeout.

Section VII.D examines the treatment of Time's freezeout of Warner under Delaware law and the *Project's* Governance rules.

7. Summary of Structure

In summary, the aspects of the *ALI Corporate Governance Project* examined here are:

(1) The basic rules in Section 4.01 regarding the duty of care and the business judgment rule;¹⁵

(2) The rules in Section 6.01 governing the role of directors and shareholders in arm's length mergers and acquisitions and the related rules regarding appraisal proceedings;¹⁶

(3) The rules of Section 5.15 governing management buyouts and the related rules regarding appraisal proceedings;¹⁷

¹⁴ See *infra* Part VII.

¹⁵ See *infra* Part II.

¹⁶ See *infra* Part III.

¹⁷ See *infra* Part IV.

(4) The rules of Section 6.02 governing the action of a target's directors that have the foreseeable effect of blocking an unsolicited tender offer;¹⁸

(5) The rules of Section 5.16 regarding the sale of shares in the target by a controlling shareholder;¹⁹ and

(6) The rules of Section 5.10 regarding both non-majority control and majority control freezeout transactions and the related rules regarding appraisal proceedings, including the exclusivity rules of Section 7.24 for majority control freeze-outs.²⁰

II. DUTY OF CARE AND BUSINESS JUDGMENT RULE

A. Introduction

The duty of care and the related business judgment rule are set forth in Section 4.01 of the *Project*. These concepts apply generally to the conduct of the board of directors and are also applicable in various merger and acquisition contexts. For that reason these concepts are addressed here.

Section 4.01(a) sets out the basic duty of care obligation of directors and officers, and Section 4.01(c) specifies the associated business judgment rule. Section 4.01(b), which authorizes delegation of functions to committees of the board or to directors, officers, employees or other persons, is not examined here. Section 4.01(d) provides that the person challenging a director or officer under Section 4.01 has the burden of proof.

In explaining the purpose of the business judgment rule, the *ALI Corporate Governance Project* says:

The basic policy underpinning of the business judgment rule is that corporate law should encourage, and afford broad protection to, informed business judgments (whether subsequent events prove the judgments right or wrong) in order to stimulate risk taking, innovation and other creative entrepreneurial activities.²¹

¹⁸ See *infra* Part V.

¹⁹ See *infra* Part VI.

²⁰ See *infra* Part VII.

²¹ 1 ALI CORPORATE GOVERNANCE PROJECT, *supra* note 1, introductory note, at 135.

The *Project* goes on to explain that because of expectations of greater profits, shareholders "accept the risk that an informed business decision — honestly undertaken and rationally believed to be in the best interests of the corporation — may not be vindicated by subsequent success."²² The *Project* further says that the protection provided by the business judgment rule is also "based on a desire to limit litigation and judicial intrusiveness with respect to private sector business decision-making."²³

The breach of the duty of care will subject the director to liability only if it is shown that acts or omissions resulting in the breach were the legal cause of damage to the corporation.²⁴

The *Project* explains the difference between the duty of care and the duty of loyalty, which the *Project* refers to as the duty of fair dealing. The duty of loyalty requires that the director not use her corporate position to make a personal profit or to otherwise gain a personal advantage.²⁵ On the other hand, the duty of care requires that the director act carefully in monitoring and directing the management of the corporation.²⁶

B. Duty of Care

Under Section 4.01(a), a director or officer has a duty to perform his or her functions "[1] in good faith, [2] in a manner that he or she reasonably believes to be in the best interest of the corporation, and [3] with the care that an ordinarily prudent person would reasonably be expected to exercise in a like position and under similar circumstances."²⁷ This duty of care includes the "obligation to make, or cause to be made, an inquiry when, but only when, the circumstances would alert a reasonable director or officer to the need therefor."²⁸ The extent of the inquiry shall be consistent with what the director or officer "reasonably believes to be necessary."²⁹ The *Project*

²² *Id.*

²³ *Id.*

²⁴ *Id.* at 136 and § 4.01(d).

²⁵ *Id.* at 137.

²⁶ *Id.*

²⁷ *Id.* § 4.01(a).

²⁸ *Id.* § 4.01(a)(1).

²⁹ *Id.*

points out that the inquiry obligation in Section 4.01(a)(1) is a "fundamental part of the duty of care obligations established in the first paragraph of § 4.01(a),"³⁰ and the purpose of Section 4.01(a)(1) is merely to provide "clarity and emphasis."³¹

In performing any of his or her functions, including oversight, a director or officer may rely on materials and persons in accordance with Sections 4.02 and 4.03.³²

This duty of care is subject to the business judgment rule, which is set out in Section 4.01(c).³³

The *Project* explains that the duty of care standard contained in Section 4.01(a) is consistent with the articulation of such standard in most jurisdictions and that the standard could be implemented entirely by judicial decision.³⁴

The *Project* points out that the use of the terms "good faith," "reasonably believes," and "like position" in Section 4.01(a), "recognize that in determining whether reasonable care has been exercised, the special skills, background, or expertise of a director or officer are properly accorded weight."³⁵

The *Project* also points out that during this century, directors or officers have been found to have violated the duty of care obligations in only about 40 appellate opinions.³⁶ Most of these involved egregious facts, such as "sustained patterns of inattention to obligations" or "unreasonable blindness to problems that later [caused] substantial harm."³⁷

C. Business Judgment Rule

The business judgment rule, which is set out in Section 4.01(c), provides that a director or officer who makes a business judgment in "good faith" fulfills the duty under Section 4.01 if the director or officer:

³⁰ *Id.* § 4.01(a)(1)-(a)(2) cmt. a, at 162.

³¹ *Id.*

³² *Id.* § 4.01(a)(2).

³³ *Id.* § 4.01(a).

³⁴ *Id.* § 4.01 cmts. a, b, at 140-41.

³⁵ *Id.* § 4.01(a) cmt. f.

³⁶ *Id.* § 4.01(a) cmt. h, at 155.

³⁷ *Id.* See, e.g., *Francis v. United Jersey Bank*, 432 A.2d 814 (N.J. 1981) (holding passive and inattentive director liable for violation of duty of care).

(1) is *not interested* [§ 1.23] in the subject of the business judgment [that is, is not a party to the transaction and has no business, financial or familial type interest in the transaction];

(2) is *informed* with respect to the subject of the business judgment to the extent the director or officer reasonably believes to be appropriate under the circumstances; and

(3) *rationally believes* that the business judgment is in the best interests of the corporation.³⁸

Section 4.01(d) provides that the person challenging the conduct of a director or officer under Section 4.01 has the burden of proving a breach of the duty of care, including the inapplicability of the provisions of Section 4.01(b), relating to delegation, and Section 4.01(c), relating to the business judgment rule. Thus, the burden of proving that the business judgment rule is not applicable is on the challenging party.

Section 4.01(d) also provides that in a damage action, the challenging party has the "burden of proving that the breach was the legal cause of damage suffered by the corporation."³⁹ As discussed in Section II.E, Delaware law does not follow the approach taken in Section 4.01(d).⁴⁰

If the challenging party meets the burden of showing that the business judgment rule is inapplicable, for example, by showing that the director was interested, or acted in bad faith or was not informed, then the "burden shifts to the director to prove that the transaction was fair and reasonable to the corporation."⁴¹ The business judgment rule has often been stated in Delaware case law as a "presumption" that a director or officer has acted properly.⁴² The word "presumption" is not used in Section 4.01(d) because it is "imprecise and subject to misinterpretation."⁴³ The effect should, however, be the same as Delaware's presumption because both the burden of coming forward with evidence and the burden of persuading the trier of fact is on those challenging a business judgment.⁴⁴

³⁸ 1 ALI CORPORATE GOVERNANCE PROJECT, *supra* note 1, § 4.01(c) (emphasis added).

³⁹ *Id.* § 4.01(d).

⁴⁰ *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345 (Del. 1993).

⁴¹ 1 ALI CORPORATE GOVERNANCE PROJECT, *supra* note 1, at 177 (quoting *Treadway Cos., Inc. v. Care Corp.*, 638 F.2d 357, 382 (2d Cir. 1980)).

⁴² *Id.* § 4.01(d) cmt. a, at 187.

⁴³ *Id.*

⁴⁴ *Id.*

The following chart compares the elements of the duty of care rule of Section 4.01(a) with the elements of the business judgment rule of Section 4.01(c):

<u>DUTY OF CARE § 4.01(a)</u>	<u>BUSINESS JUDGMENT RULE § 4.01(c)</u>
Duty of Care is Satisfied if Director or Officer:	Business Judgment Rule is Satisfied if Director or Officer:
[1] Performs functions in good faith;	[1] Makes a business judgment in good faith;
[2] Performs in a manner he or she [reasonably believes] to be in the best interests of the corporation;	[2] [Rationally] believes that the business judgment is in the best interests of the corpo- ration;
[3] Performs with the care that an ordinarily prudent person would reasonably be expected to exercise in a like position under similar circumstances;	[3] Not applicable;
[4] Makes inquiry when, but only when, the circumstances would alert a reasonable direc- tor or officer to the need there- for;	[4] Is informed with respect to the subject of the business judgment to the extent the director or officer reasonably believes to be appropriate un- der the circumstances;
[5] Not applicable.	[5] Is not interested in the subject of the business judg- ment.

There are four salient differences between the duty of care and the business judgment rule.

First, the business judgment rule applies only where there is a conscious decision, whereas the duty of care encompasses an ongoing duty of oversight and stewardship irrespective of decision-making.

Second, the business judgment rule is available only for disinterested transactions, whereas the duty of care obligation applies to both interested and disinterested transactions. However, if the director is interested in the transaction, the conduct or transaction will be tested under Part V of the *Project*, which deals with the duty of fair dealing.

Third, to satisfy the duty of care, the performance by the director must be in a manner the director "reasonably believes" is in the best interest of the corporation, whereas, under the business judgment rule, the director must have a "rational belief" that the business judgment is in the best interest of the corporation. The "rational belief" standard is less difficult to satisfy than the "reasonably believes" standard. As pointed out by Professor Goldschmid, one of the draftsmen of the *Project*:

This [rational belief] standard is intended to provide directors and officers with a wide ambit of discretion. Although the words have close etymological ties, a sharp distinction is drawn in § 4.01 between the words "reasonable" and "rational." The phrase "rationally believes" is intended to permit a significantly wider range of discretion than the term "reasonable," and to give a director or an officer a safe harbor from liability for business judgments that might arguably fall outside the term "reasonably" but are not so removed from the realm of reason when made that liability should be incurred.⁴⁵

This rational belief standard is explored further below.

Fourth, to satisfy the duty of care, the director's performance must meet the standard of care that an ordinarily prudent person would reasonably be expected to exercise in a like position under similar circumstances; however, there is no such explicit element in the business judgment rule. In effect, this care element is presumed to be satisfied if the business judgment rule is satisfied. Thus, the standard of conduct set forth in the duty of care has a higher threshold than the standard of review set forth in the business judgment rule.

The *Project* points out that there are no statutory formulations of the business judgment rule; the rule has been devel-

⁴⁵ Harvey J. Goldschmid, *Outline on the Duty of Care and the Business Judgment Rule*, in ALI-ABA, ALI'S PRINCIPLES OF CORPORATE GOVERNANCE 47 (Oct. 6-7, 1994).

oped in the case law.⁴⁶ The formulation of the rule in Section 4.01(c) is thought to be consistent with the formulation of the rule under present law in most jurisdictions.⁴⁷ The *Project* explains that the business judgment rule offers a safe harbor for an informed business decision that the officer or director rationally believes is in the best interests of the corporation.⁴⁸

As noted above, the rule only protects affirmative business judgments, including decisions not to act; cases involving omissions are to be judged under the reasonable care standard of Section 4.01(a).⁴⁹ In support of this proposition the *Project* contains the following quote from the Delaware Supreme Court's decision in *Aronson v. Lewis*:⁵⁰ "[T]he business judgment rule operates only in the context of director action. . . . [I]t has no role where directors have either abdicated their functions, or absent a conscious decision, failed to act."⁵¹

The *Project* points out that "[i]t is well settled that good faith and disinterested decision-making are prerequisites to entry into the business judgment rule's safe harbor."⁵² Further, if the challenging party can establish the inapplicability of the business judgment rule, then the burden shifts to the director to establish that the due care standard was met.⁵³

The *Project* points out that the requirement in Section 4.01(c)(2) of informed decision making "focuses on the preparedness of a director or officer in making a business decision as opposed to the quality of the decision itself."⁵⁴ The *Project* further points out that the "reasonably believes" standard, set forth in Section 4.01(c)(2), for determining the level of inquiry has "both an objective and a subjective content."⁵⁵ This requirement should be "interpreted realistically and with an appreciation of the factual context in which the business judgment

⁴⁶ 1 ALI CORPORATE GOVERNANCE PROJECT, *supra* note 1, at 173.

⁴⁷ *Id.* § 4.01(c) cmt. a, at 173.

⁴⁸ *Id.*

⁴⁹ *Id.* § 4.01(c) cmt. c, at 174-75.

⁵⁰ 473 A.2d 805, 813 (Del. 1984).

⁵¹ 1 ALI CORPORATE GOVERNANCE PROJECT, *supra* note 1, § 4.01(c) cmt. c, at 175.

⁵² *Id.* cmt. d, at 176.

⁵³ *Id.* at 176-77.

⁵⁴ *Id.* cmt. e, at 177.

⁵⁵ *Id.* at 178.

was made."⁵⁶ Thus, the time that is realistically available is taken into account in determining whether a proper inquiry has been made.

With respect to the law in Delaware on this issue, the *Project* quotes *Smith v. Van Gorkom*⁵⁷ as follows: "the directors were duty bound to make reasonable inquiry."⁵⁸ Further, the *Project* says that the *Van Gorkom* decision requires directors to inform "themselves 'prior to making a business decision, of all material information reasonably available to them'"⁵⁹ The *Project* goes on to point out, however, that *Van Gorkom* applies a "gross negligence" test in determining whether a business judgment was "an informed one."⁶⁰

The requirement, set forth in Section 4.01(c)(3), that the director "rationally believe" that the decision is in the best interests of the corporation also has both an objective and a subjective content.⁶¹ To satisfy this requirement the "director or officer must actually believe that the business judgment is in the best interests of the corporation and that belief must be rational."⁶²

The *Project* says that this "rationally believes" standard is consistent with a line of Delaware cases, including *Panter v. Marshall Field & Co.*,⁶³ where the court said that it would not disturb a business judgment if "any rational business purpose can be attributed" to the director's decision; *Unocal Corp. v. Mesa Petroleum Co.*,⁶⁴ where the court adopted an "any rational business purpose" test; and *Sinclair Oil Corp. v. Levien*,⁶⁵ where the court adopted a "rational business purpose" test.⁶⁶ The *Project* also cites by comparison *In re RJR Nabisco, Inc. Shareholders Litigation*,⁶⁷ where the court said:

⁵⁶ *Id.*

⁵⁷ 488 A.2d 858 (Del. 1985).

⁵⁸ 1 ALI CORPORATE GOVERNANCE PROJECT, *supra* note 1, § 4.01(c) cmt. f, at 179.

⁵⁹ *Id.* cmt. e, at 177.

⁶⁰ *Id.*

⁶¹ *Id.* cmt. f, at 179.

⁶² *Id.*

⁶³ 646 F.2d 271, 293 (7th Cir. 1981).

⁶⁴ 493 A.2d 946, 954 (Del. 1985).

⁶⁵ 280 A.2d 717, 720 (Del. 1971).

⁶⁶ 1 ALI CORPORATE GOVERNANCE PROJECT, *supra* note 1, § 4.01(c) cmt. f, at 179.

⁶⁷ *In re RJR Nabisco, Inc. Shareholders Litigation*, No. Civ. A. 10389, 1989

"As I conceptualize the matter, such limited subjective review as the rule contemplates (i.e., is the judgment under review 'egregious' or 'irrational' or 'so beyond reason,' etc.) really is a way of inferring bad faith."⁶⁸

D. Illustration of Application of the Business Judgment Rule to an Acquiring Corporation

The reasonably informed and the rational belief tests are illustrated by an example in which the board of directors of a potential acquiring corporation (white knight) decides on short notice to make a tender offer for a target corporation that was already the subject of a tender offer. Another corporation had made a tender offer for the target at \$48 per share, and two days before the closing of that tender offer, at the urging of the directors of the target and upon the advice of the officers of the white knight, the white knight made a competing tender offer at \$49 per share. The offer was made even though the officers of the white knight did not have adequate time to evaluate the target's research and development operations and several other significant aspects of its business. The decision to make the tender offer was made on the basis of an evaluation and discussion of all available information even though the information was imperfect.

In the example, the decision to make the tender offer is protected by the business judgment rule. This is so because pursuant to the requirement of Section 4.01(c)(2) the "directors acted reasonably in believing that they were informed to the extent appropriate under the circumstances[.]"⁶⁹ and pursuant to the requirement of Section 4.01 (c)(3), the directors "rationally believe[d] that their business judgment [was] in the best interest of the corporation."⁷⁰ The example also shows that a decision by the directors not to make the acquisition would also be protected by the business judgment rule.

WL 7036 (Del. Ch. Jan. 31, 1989), *appeal refused by*, 556 A.2d 1070 (Del. Ch. 1989).

⁶⁸ 1 ALI CORPORATE GOVERNANCE PROJECT, *supra* note 1, § 4.01(c) cmt. f, at 179.

⁶⁹ *Id.* at 182.

⁷⁰ *Id.* § 4.01(c)(3), at 139.

E. Observations

The above example of the actions taken by an acquiring corporation illustrates that it will, indeed, be a rare situation in which the business judgment rule will not protect the directors of an acquiring corporation in deciding to make, or not to make, an acquisition of a target. Indeed, there appear to be no cases in which the directors of an acquiring corporation have been denied protection under the business judgment rule. As illustrated in *Smith v. Van Gorkom*, this is not the case with the directors of target corporations.

In *Cede & Co. v. Technicolor, Inc. (Technicolor II)*,⁷¹ the Delaware Supreme Court did not follow the approach of Section 4.01(d) of the *Project*, which provides that in a damages action, the challenging party has the "burden of proving that the breach was the legal cause of damages suffered by the corporation."⁷² In that case, MacAndrews & Forbes Group Incorporated (MAF) acquired Technicolor in a two-step tender offer, freezeout transaction. Cinerama, Inc., a shareholder of Technicolor, dissented in the freezeout merger and sought appraisal of its shares. In the course of the appraisal proceeding, Cinerama discovered evidence of fraud and, therefore, amended its appraisal proceeding to include a fraud count. In *Technicolor I*,⁷³ the Supreme Court of Delaware had held that the Court of Chancery erred in requiring Cinerama to make an election of remedies before trial. Upon remand, the Court of Chancery rendered its appraisal opinion first, finding that the fair value of Technicolor shares held by Cinerama was \$ 21.60 per share even though MAF had paid \$23 per share in the tender offer and in the freezeout merger.⁷⁴

In *Technicolor II*, the Delaware Supreme Court found that the Technicolor board had violated its duty of care, reasoning:

Applying *Van Gorkom* to the trial court's presumed findings of director and board gross negligence, we find the defendant directors, as a board, to have breached their duty of care by reaching an uninformed decision on October 29, 1982, which consisted of

⁷¹ 634 A.2d 345 (Del. 1993) (*Technicolor II*).

⁷² 1 ALI CORPORATE GOVERNANCE PROJECT, *supra* note 1, § 4.01(d).

⁷³ 542 A.2d 1182 (Del. 1988) (*Technicolor I*).

⁷⁴ *Cede & Co. v. Technicolor, Inc.*, No. Civ. A. 7129, 1990 WL 161084 (Del. Ch. Oct. 19, 1990) (*Technicolor Appraisal Decision*).

approving the sale price of \$23. We hold that the merger plan approved by the defendant directors on October 29, 1982, must, on remand, be reviewed for its entire fairness, applying *Weinberger*.⁷⁵

Also, in *Technicolor II*, the Delaware Supreme Court rejected the Chancellor's approach of requiring Cinerama to prove injury in order to rebut the presumption of the business judgment rule. The Chancellor had found that the proof of injury element had not been met because of the earlier finding in the *Technicolor Appraisal Decision* that the fair value of the shares was \$21.60.⁷⁶ The Delaware Supreme Court described the Chancellor's approach as follows:

The Chancellor concluded that the 'fatal weakness in plaintiff's case' was plaintiff's failure to prove that it had been injured as a result of the defendant's negligence. The court put it this way:

'It is not the case, in my opinion, that in an *arm's-length third party merger*, proof of a breach of the board's duty of care itself *entitles plaintiff to judgment*. Rather, in such a case, as in any case in which the gist of the claim is negligence, plaintiff bears the burden to establish that the negligence shown was the proximate cause of some injury to it and what the injury was.'⁷⁷

The court went on to explain that if the plaintiff was required to show damages, the directors who were found to have breached their duty of care would be relieved of establishing the entire fairness of the transaction under the *Weinberger* standard.⁷⁸ In remanding for a determination of the entire fairness of the transaction, the court said that the "measure of any recoverable loss by Cinerama under an entire fairness standard of review is not necessarily limited to the difference between the price offered and the 'true' value as determined under appraisal proceedings."⁷⁹ And, the court added that "[u]nder *Weinberger*, the Chancellor may fashion any form of equitable

⁷⁵ *Technicolor II*, 634 A.2d at 367.

⁷⁶ *Cede & Co. v. Technicolor, Inc.*, No. Civ. A. 7129, 1990 WL 161084 (Del. Ch. Oct. 19, 1990).

⁷⁷ *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 368-69 (Del. 1993) (citing *Barnes v. Andrews*, 298 F. 614, 616-18 (S.D.N.Y. 1924)).

⁷⁸ *Id.* at 369.

⁷⁹ *Id.* at 371.

and monetary relief as may be appropriate, including recissory damages."⁸⁰

In the opinion after remand in *Technicolor II*, the Chancellor pointed out that his initial position to the effect that the plaintiff must show that the director's negligent breach was the proximate cause of the injury suffered is consistent with the approach taken by the *Project* in Section 4.01(d).⁸¹ The Chancellor expressed the view that the entire fairness rule should apply only where the duty of loyalty is violated. The Chancellor went on to say:

That this Delaware version of the meaning and operation of the business judgement rule makes that rule a liability enhancing rule (i.e., it disadvantages director defendants when compared to other classes of persons charged with negligently causing injury to another) was not the subject of comment in the court's opinion.⁸²

The Chancellor went on to find that the defendants satisfied their burden of establishing that the transaction was entirely fair. Also, the Chancellor found that the plaintiffs were not entitled to recissory damages because the Technicolor directors did not "profit at the plaintiffs' expense via the MAF transaction."⁸³

The Delaware Supreme Court in *Technicolor III*⁸⁴ affirmed the Chancellor's finding that the transaction was entirely fair. The court said that under the entire fairness test, the defendant must show that the price offered was the "highest price reasonably available[.]"⁸⁵ and the court, in an elaborate analysis, demonstrated why the Chancellor was correct in finding the transaction entirely fair.

⁸⁰ *Id.*

⁸¹ *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1134, 1137 (Del. Ch. 1994).

⁸² *Id.*

⁸³ *Id.* at 1147.

⁸⁴ *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156 (Del. 1995)

⁸⁵ *Id.* at 1177.

III. ARM'S LENGTH MERGERS AND ACQUISITIONS

A. Introduction to Section 6.01

Section 6.01(a) governs the actions of a target's directors in a transaction in control, and Section 6.01(b) specifies the votes required by the shareholders of both the acquiror and the target in a transaction in control. The *Project* explains that Section 6.01(a) does not, however, apply to actions taken by a target's directors in resisting a tender offer to the target's shareholders, or to a transaction in control in which the target's directors or principal senior executives are interested, that is, a management buyout.⁸⁶ Also, Section 6.01(a) has no role in freezeout transactions. Thus, Section 6.01(a) provides governance rules only for a target's directors in arm's length transactions in control.

Defensive actions in tender offers are governed by Section 6.02;⁸⁷ management buyouts are governed by Section 5.15;⁸⁸ and freezeouts are governed by Section 5.10 and 7.25.⁸⁹

Section 6.01(a) provides that a target's board of directors in the exercise of its business judgment, as provided in Section 4.01(c),⁹⁰ "may approve, reject, or decline to consider a proposal to the corporation to engage in a transaction in control"⁹¹ Section 6.01(b) provides that a "transaction in control of the corporation to which the corporation is a party should require approval by the shareholders"⁹²

B. Definition of Transaction in Control

The term "transaction in control" is defined in Section 1.38 of the *Project* to embrace the following three forms of acquisition:

⁸⁶ 1 ALI CORPORATE GOVERNANCE PROJECT, *supra* note 1, § 6.01 cmt. a(1), at 389.

⁸⁷ See *infra* Part V.

⁸⁸ See *infra* Part IV.

⁸⁹ See *infra* Part VII.

⁹⁰ See *supra* Part II.C.

⁹¹ 1 ALI CORPORATE GOVERNANCE PROJECT, *supra* note 1, § 6.01(a).

⁹² *Id.* § 6.01(b).

(1) A business combination effected [either directly or by means of a subsidiary] through (1) a merger, (2) a consolidation, (3) an issuance of voting equity securities [for, in essence, substantially all of the assets of another corporation], or (4) an issuance of voting equity securities in exchange for at least a majority of the voting equity securities of another corporation . . . ;

(2) A sale of assets that would leave the corporation without a significant continuing business;

(3) An issuance of securities or any other transaction by the corporation [(other than a business combination described in the first paragraph above)] that, alone or in conjunction with other transactions or circumstances, causes a change in control . . . of the corporation. . . .⁹³

Under this broad definition, "transactions in control" encompass various forms of transactions in which the stock or assets of a target are acquired, including management buyouts. In all of these transactions, the *Project* gives the target's shareholders and, subject to the continuity of interest rule of Section 1.38(b)(3), discussed below, the acquiror's shareholders, the right to vote.⁹⁴

It is important to note that a "transaction in control" does not include the acquisition of stock of a target through a cash tender offer to the shareholders of the target.⁹⁵ However, under the first form of acquisition listed in Section 1.38 of the *Project* above, a "transaction in control" occurs in subsection (4) with respect to the acquiror (but not the target) on the acquisition by the acquiror of at least a majority of the target's stock in exchange for voting stock of the acquiror. Thus, a tax-free stock for stock reorganization under Section 368(a)(1)(B) of the Internal Revenue Code in which an acquiror acquires at least 80% of the stock of a target in exchange for voting stock of the acquiror would constitute a transaction in control for the acquiror, unless the continuity of interest rule of Section 1.38(b)(3), which is discussed below, applies.

Under the above definition, transactions in control also encompass all forms of subsidiary mergers, except where the continuity of interest rule applies. Thus, for example, in a reverse subsidiary merger in which a subsidiary of the acquiror merges

⁹³ *Id.* § 1.38(a).

⁹⁴ *Id.* § 6.01(b).

⁹⁵ *Id.* § 1.38 cmt. c, at 45.

into the target with the target's shareholders receiving stock of the acquiror, the merger is a transaction in control with respect to both the acquiror and the target, unless the continuity of interest rule applies.

Under Section 1.38(b)(3), which sets out a continuity of interest rule, a transaction in control does not include, inter alia, a merger or similar transaction described under Section 1.38(a)(1) above, if those persons who were the "holders of voting equity securities in the corporation immediately before the transaction would own immediately after the transaction at least 75 percent of the surviving corporation's voting equity securities, in substantially the same proportions in relation to other preexisting shareholders of the corporation."⁹⁶ Thus, for example, if the shareholders of the acquiror continue to own at least 75% of the acquiror's stock after a merger or stock for stock acquisition, the transaction is not a transaction in control with respect to the acquiror. This rule is consistent with Section 251(f) of the Delaware General Corporation Law and Section 11.03(g)(3) of the Revised Model Business Corporation Act, although both of those provisions contain a 20% dilution standard.⁹⁷

Section 1.38 represents a codification of the de facto merger doctrine. Under this doctrine, courts have treated acquisitions that in form are not mergers as mergers in substance, thereby giving the target's shareholders voting and appraisal rights. The *Project* explains that "Section 1.38 seeks to avoid the difficulties encountered by courts and legislatures in dealing with the de facto merger problem by defining the range of transactions of concern by reference to their substance, rather than their form."⁹⁸

The Pennsylvania Supreme Court followed the ALP's approach in *Farris v. Glen Alden Corp.*,⁹⁹ where it treated a purchase of a target's assets as a merger. Thus, the *Project* rejects the "equal dignity" approach taken by the Delaware Supreme Court in *Hariton v. Arco Electronics, Inc.*¹⁰⁰ The *Project* ex-

⁹⁶ *Id.* § 1.38(b)(3).

⁹⁷ DEL. CODE ANN. tit. 8, § 251(f) (1990); MODEL BUS. CORP. ACT § 11.03(g)(3) (1994).

⁹⁸ 1 ALI CORPORATE GOVERNANCE PROJECT, *supra* note 1, § 1.38 cmt. c(1), at 44.

⁹⁹ 143 A.2d 25 (Pa. 1958)

¹⁰⁰ 188 A.2d 123 (Del. 1963).

plains that the equal dignity doctrine treats the "alternative transactional forms authorized by the corporate statute — merger, triangular merger, and sale of assets — as of 'equal dignity,' with the result that the planner's choice of transaction form is respected."¹⁰¹ The next section illustrates several situations in which the *Project* incorporates the de facto merger doctrine.

C. General Impact of Shareholder Vote Requirement Under Section 6.01(b)

The requirement in Section 6.01(b) for a shareholder vote on transactions in control, as defined in Section 1.38,¹⁰² is designed to mandate such vote without regard to the form the transaction takes. Thus, Section 6.01(b) and Section 1.38 implement the de facto merger doctrine¹⁰³ with regard to shareholder voting by providing for voting by the shareholders of both the target and the acquiring corporation in virtually all merger and acquisition transactions in which board action is required. As indicated in Section III.F.2, a similar de facto merger standard applies for purposes of determining appraisal rights.

As indicated above, a shareholder vote is not required by the shareholders of either the target or the acquiror if such shareholders own at least 75% of the stock of the surviving corporation.¹⁰⁴

The implementation of the de facto merger doctrine can be illustrated by considering the treatment under the *Project* of the asset acquisition in *Farris v. Glen Alden Corp.*,¹⁰⁵ the triangular merger in *Terry v. Penn Central Corp.*,¹⁰⁶ and the stock acquisitions in *Orzech v. Englehart*¹⁰⁷ and in *Applestein v. United Board and Carton Corp.*¹⁰⁸

¹⁰¹ 1 ALI CORPORATE GOVERNANCE PROJECT, *supra* note 1, § 1.38 cmt. a, at 43.

¹⁰² See *supra* Part III.B.

¹⁰³ 1 ALI CORPORATE GOVERNANCE PROJECT, *supra* note 1, § 6.01 cmt. a, at 389-90. The treatment of the de facto merger doctrine under the ALI rules is not examined here in detail.

¹⁰⁴ *Id.* at 390; see *id.* § 1.38(b)(3).

¹⁰⁵ 143 A.2d 25 (Pa. 1958).

¹⁰⁶ 668 F.2d 188 (3d Cir. 1981).

¹⁰⁷ 195 A.2d 375 (Del. 1963).

¹⁰⁸ 159 A.2d 146 (N.J. Super. Ct. Ch. Div. 1960), *aff'd*, 161 A.2d 474 (N.J. 1960).

In *Glen Alden*, the corporation that was actually the target (the real target) acquired in exchange for its stock the assets and liabilities of the corporation that was in fact the acquiror (the real acquiror), and the real acquiror was liquidated, distributing the stock received to its shareholders. As a result of the transaction, the shareholders of the real acquiror ended up controlling the real target.¹⁰⁹

Under the Pennsylvania business corporation law, the shareholders of the real target were not given a vote on the transaction because the real target had not engaged in a merger and had not disposed of all or substantially all of its assets, but rather had merely issued authorized but unissued shares in the acquisition of the assets of the real acquiror. On the other hand, since the real acquiror had disposed of "substantially all" of its assets, its shareholders were given a vote. The Pennsylvania Supreme Court, in adopting the de facto merger doctrine, held that in light of the "consequences of the transaction and . . . the purposes of the [merger] provisions of the corporation law . . .,"¹¹⁰ the transaction was the economic equivalent of a merger and would be treated as such. Consequently, the shareholders of the real target were given the right to vote and to dissent on the transaction.

Under Sections 1.38(a)(1)(ii) and (a)(2) of the *Project*, the transaction in *Glen Alden* would be a transaction in control of (1) the real target, because it has issued its stock in exchange for all of the assets of the real acquiror,¹¹¹ and (2) the real acquiror because it has sold its assets and does not have a significant continuing business.¹¹² Consequently, under Section 6.01(b), the shareholders of both corporations would have the right to vote, unless the shareholders of the real acquiror ended up with at least 75% of the stock of the real target, in which case the shareholders of the real acquiror would not have the right to vote.

Terry v. Penn Central Corp. involved a forward triangular merger in which Penn Central (the acquiring parent) was going to acquire Colt Industries (the target) by having Colt merge

¹⁰⁹ *Farris v. Glen Alden Corp.*, 143 A.2d 25 (Pa. 1958).

¹¹⁰ *Id.* at 28.

¹¹¹ 1 ALI CORPORATE GOVERNANCE PROJECT, *supra* note 1, § 1.38(a)(1)(ii).

¹¹² *Id.* § 1.38(a)(2).

into a wholly-owned subsidiary (acquiring sub) of Penn Central.¹¹³ The Pennsylvania business corporation law did not give the shareholders of Penn Central a vote on the transaction because Penn Central was not a party to the merger. The two parties to the merger were the acquiring sub and the target. Shareholders of Penn Central challenged the transaction on the grounds that the acquisition was a de facto merger involving Penn Central, and consequently, the shareholders of Penn Central had the right to vote and to dissent.¹¹⁴ The Third Circuit, applying Pennsylvania law, first noted that the Pennsylvania legislature had overridden the de facto merger doctrine as adopted by *Glen Alden*, and consequently, the court refused to treat Penn Central, the acquiring Parent, as a party to the merger. Therefore, the shareholders of Penn Central did not have the right to vote or to dissent on the transaction.¹¹⁵

In this regard, Pennsylvania follows Delaware law under which it is clear that the shareholders of the acquiring parent in a triangular merger do not have the right to vote because (1) the statute does not explicitly grant such a right,¹¹⁶ and (2) Delaware has rejected the de facto merger doctrine in favor of the equal dignity principle.¹¹⁷

Under Section 1.38(a)(1)(i) of the *Project*, the triangular merger in Penn Central would be a transaction in control with respect to both the acquiring parent (Penn Central) and the target, because the transaction is a merger effected by means of a subsidiary. Consequently, the shareholders of both Penn Central and the target would have the right to vote, unless the shareholders of Penn Central held at least 75% of the stock of Penn Central after the merger, in which case the shareholders of Penn Central would not vote. Thus, the *Project* in essence, rejects the holding of *Penn Central* and applies the de facto merger doctrine to triangular mergers.

The *Project* also rejects the application of the equal dignity principle by the Delaware Supreme Court in the stock acquisi-

¹¹³ 668 F.2d 188 (3d Cir. 1981).

¹¹⁴ *Id.* at 189-90.

¹¹⁵ See also *Equity Group Holdings v. DMG, Inc.*, 576 F. Supp. 1197 (S.D. Fla. 1983) (reaching the same result under Florida law).

¹¹⁶ The acquiring parent is not a constituent corporation. See DEL. CODE ANN. tit.8, § 251(c) (199_).

¹¹⁷ See, e.g., *Hariton v. Arco Elec., Inc.*, 188 A.2d 123 (Del. 1963).

tion in *Orzeck v. Englehart*.¹¹⁸ There, in essence, the real target issued its stock to the shareholders of the real acquiror in exchange for all of the stock of the real acquiror.¹¹⁹ The shareholders of the real acquiror ended up in control of the real target, which was in control of the real acquiror. After the acquisition, the real acquiror was merged upstream into the real target. Following *Hariton v. Arco Electronics, Inc.*,¹²⁰ the Delaware Supreme Court again rejected the de facto merger principle and did not give the shareholders of the real target the right to vote or dissent on the transaction.

Under Section 1.38(a)(1)(iv) of the *Project*, the transaction in *Orzeck* would be a transaction in control of the real target, because it issued its stock "in exchange for at least a majority of the voting equity securities of another corporation."¹²¹ Consequently, under Section 6.01(b) the shareholders of the real target would have the right to vote on the transaction.

In adopting this principle, the *Project* thus codifies the application of the de facto merger principle by the New Jersey Supreme Court in the stock acquisition in *Applestein v. United Board and Carton Corp.*¹²² There the real target issued 40% of its stock to the controlling shareholder of the real acquiror. After the acquisition the real acquiror merged into the real target. The court treated the transaction as de facto merger. Presumably, if the merger had not taken place the court would not have applied the de facto merger principle. Under the ALI approach in Section 1.38(a)(1)(iv), the stock issuance in *Applestein* would be treated as a transaction in control of the real target because the real target issued its shares in exchange for at least a majority of the shares of the real acquiror, and the shareholders of the real target did not own at least 75% of the stock of the real target (they owned only 60%) after the transaction. This result obtains under the *Project* even if there is no merger after the stock acquisition.

¹¹⁸ 195 A.2d 375 (Del. 1963).

¹¹⁹ *Id.* at 376.

¹²⁰ *Hariton*, 188 A.2d at 123.

¹²¹ 1 ALI CORPORATE GOVERNANCE PROJECT, *supra* note 1, § 1.38(a)(1)(iv).

¹²² 159 A.2d 146 (N.J. Super. Ct. Ch. Div. 1960), *aff'd*, 161 A.2d 474 (N.J. 1960).

D. General Impact of Director Action Requirement Under Section 6.01(a): The Business Judgment Rule

1. Basic Concepts

Section 6.01(a) governs the actions of a target's board of directors in a consensual merger or acquisition transaction. Under this provision, the target's board may in the exercise of its business judgment, as provided in Section 4.01(c),¹²³ "approve, reject, or decline to consider a proposal to the corporation to engage in a transaction in control."¹²⁴

The *Project* explains that Section 6.01(a) is consistent with existing law, such as Section 141 of the Delaware General Corporation Law, which provides that the directors shall manage the corporation.¹²⁵ Furthermore, the *Project* explains that review of a director's decision would be under the business judgment rule in Section 4.01(c) for the "purpose of determining both entitlement to injunctive relief against the directors' decision and the liability, if any, of the directors for their decision."¹²⁶ The *Project* does not address the extent to which a corporate charter may provide for other rules governing transactions in control, such as a fair price provision that requires an extraordinary shareholder vote for a second step merger providing for different consideration than that paid in the first step.¹²⁷

The *Project* emphasizes that the target's directors do not "necessarily have an obligation even to consider a proposed transaction in control."¹²⁸ The *Project* explains that "a policy decision by the directors that the shareholders would be best served by management concentrating its attention on operating the corporation's business, rather than selling it, would be reviewed under the business judgment rule."¹²⁹ On this point, the *Project* says that "[m]anagement need not act as if the business of the corporation is at all times up for sale."¹³⁰

¹²³ See *supra* Part II.C.

¹²⁴ 1 ALI CORPORATE GOVERNANCE PROJECT, *supra* note 1, § 6.01(a).

¹²⁵ See DEL. CODE ANN. tit. 8, § 141 (1991 & Supp. 1994).

¹²⁶ *Id.* § 6.01 cmt. a, at 389.

¹²⁷ *Id.* reporter's note 4, at 400.

¹²⁸ *Id.* cmt. c, at 390.

¹²⁹ *Id.*

¹³⁰ *Id.*

Although the directors are not required to take affirmative steps with regard to a particular proposal, if they seek shareholder approval on a particular transaction, they must inform the shareholders of "any pending, concrete, and clearly defined alternative proposal."¹³¹ Further, unless limited by statute or charter provision, the directors have the power under the by-laws to set reasonable ground rules regarding the existence of shareholder voting rights.¹³²

The *Project* "takes no position on the validity of lock-ups granted by the board of directors, without shareholder approval"¹³³ Lock-up devices are designed to protect a negotiated transaction with a favored party from competition from other parties by granting the favored party an option to acquire the target's newly issued shares or selected assets, such as the crown jewels.¹³⁴ The stock option agreement used in the Time-Warner acquisition is one illustration of a lock-up.¹³⁵ The *Project* points out that existing law does not provide a consistent mode of analysis of lock-ups. Although some decisions have "upheld the validity of lock-up devices" by following the "routine application of the business judgment rule,"¹³⁶ other cases have "invalidated lock-up devices by application of a more rigorous standard of review"¹³⁷ For example, the *Mills Acquisition Co. v. MacMillan, Inc.*, decision stated that defensive measures that treat bidders unequally are subject to the "enhanced judicial scrutiny" standard set out in *Unocal*.¹³⁸

Further, Section 6.01(a) would allow, in an appropriate case, the target's directors to cause the corporation to enter a stand-

¹³¹ *Id.* at 391.

¹³² *Id.* cmt. d, at 392.

¹³³ *Id.* at 393.

¹³⁴ *Id.*

¹³⁵ See *supra* Part I.B.

¹³⁶ 1 ALI CORPORATE GOVERNANCE PROJECT, *supra* note 1, § 6.01 reporter's note 8, at 404. See *Crouse-Hinds Co. v. Inter North*, 634 F.2d 690 (2d Cir. 1980); *Buffalo Forge Co. v. Ogden Corp.*, 717 F.2d 757 (2d Cir. 1983), *cert. denied*, 464 U.S. 1018 (1983).

¹³⁷ 1 ALI CORPORATE GOVERNANCE PROJECT, *supra* note 1, reporter's note 8, at 404. See *Hanson Trust PLC v. ML SCM Acquisition, Inc.*, 781 F.2d 264 (2d Cir. 1986); *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986).

¹³⁸ 1 ALI CORPORATE GOVERNANCE PROJECT, *supra* note 1, reporter's note 8, at 405. See *Mills Acquisition Co. v. MacMillan, Inc.*, 559 A.2d 1261, 1289 (Del. 1989).

still agreement, under which a potential acquiring corporation agrees not to make a tender offer without the approval of the target's board.¹³⁹

The *Project* also indicates that the requirement in Section 6.01(b) for shareholder approval is not intended to suggest the invalidity of agreements (made by the target's board without shareholder approval) that obligate a corporation to reimburse the reasonable expenses of, or to pay an incentive or topping fee to, an unsuccessful competing bidder, provided such fee would not reasonably be expected to deter other bidders.¹⁴⁰

The *Project* points out that a target's directors fulfill their obligations under the business judgment rule of Section 4.01(c) if they satisfy the following conditions:

- (1) *inform* themselves to the extent they reasonably believe to be appropriate under the circumstances before making a decision,
- (2) act in *good faith*,
- (3) without being *interested* . . . in the subject of the decision, and
- (4) *rationaly believe* that their action is in the best interests of the corporation.¹⁴¹

These elements are examined in Sections III.D.2, 3, and 4, immediately below. As indicated in Section III.F.5, *infra*, if the business judgment rule is satisfied and certain other basic conditions are met, appraisal is the exclusive remedy for the corporation's shareholders.

2. Duty to Inform

With regard to the duty of the directors to be informed, the *Project* first points out that transactions in control can be extremely complex and that it is essential that directors be able to rely on the advice of others and "not be faulted for reasonable decisions not to read lengthy legal documents or conduct a detailed cross-examination of those upon whom they reasonably rely."¹⁴²

¹³⁹ 1 ALI CORPORATE GOVERNANCE PROJECT, *supra* note 1, reporter's note 8, at 405.

¹⁴⁰ *Id.* § 6.01 cmt. d, at 393.

¹⁴¹ *Id.* § 6.01 cmt. e, at 393-94 (emphasis added).

¹⁴² *Id.* at 394.

The *Project* further says that whether fair value is “given or received in a transaction in control is often susceptible of widely varying opinions.”¹⁴³ Although valuation opinions of experts may be helpful, directors should not be required to obtain such opinions “at the risk of incurring personal liability if they fail to do so, unless it is clear that internal resources are unavailable to satisfy the directors’ duty of inquiry.”¹⁴⁴

The *Project* says that the directors are not required to determine a “single ‘intrinsic’ value of their corporation”¹⁴⁵ and that “[a]ny suggestion in *Smith v. Van Gorkom* that directors have a duty to ascertain a single intrinsic value is not adopted.”¹⁴⁶

In discharging their responsibilities under Section 6.01(a), the directors of the target are generally not required to “initiate a formal auction of the corporation, in which the corporation is sold to the highest bidder”¹⁴⁷ If the directors “have reasonably informed themselves as to their corporation’s worth, they may enter into a negotiated agreement to sell the corporation to an unrelated third party for what they consider to be fair value.”¹⁴⁸ Also, the directors may bind themselves not to negotiate with others pending completion of the transaction, “provided they do not interfere with the ability of the shareholders to reject the proposed transaction or to accept a competing proposal.”¹⁴⁹

If the target’s directors satisfy the business judgment rule under Section 4.01(c), they will not be held responsible for “loss of a bid submitted on condition that it be accepted within a limited time period specified by the bidder, or on condition that the bidder receive preferential treatment.”¹⁵⁰ The target’s directors may reject all bids; however, if they do not reject all the bids and a bidding contest develops, the “directors will be obligated to accept the bid that is most favorable to the shareholders unless another bid would not significantly disfavor the long-

¹⁴³ *Id.*

¹⁴⁴ *Id.*

¹⁴⁵ *Id.*

¹⁴⁶ *Id.* at 395.

¹⁴⁷ *Id.*

¹⁴⁸ *Id.*

¹⁴⁹ *Id.*

¹⁵⁰ *Id.*

term interests of the shareholders and would better protect the interests of groups other than the shareholders with which the corporation has a legitimate concern"¹⁵¹ Thus, to a limited extent, the directors may give consideration to the interests of other constituencies. The standard of not significantly disfavoring the long-term interests of the shareholders is explicitly set forth in Section 6.02, which governs defensive tactics in tender offers.¹⁵² It is not, however, explicitly set forth in Section 6.01.

If a bidding contest develops the directors may in the exercise of their business judgment provide for a mechanism for ending the contest, including the use of lock-up devices, provided the intent to end and the manner of ending the bidding contest is communicated to all of the bidders.¹⁵³

If the target is being sold for securities of a publicly traded acquiring corporation, the target's directors should be entitled to rely on the SEC filings of the acquiring corporation, unless the directors have reason to believe that the SEC filings are inaccurate or require further investigation.¹⁵⁴ If the acquiring corporation is privately held, the target's directors should "insist on sufficient information upon which they can rely to satisfy themselves as to the value of the securities they have received"¹⁵⁵

3. Disclosure and Approval Negate Personal Liability

Finally, even if disinterested directors fail to satisfy the business judgment rule, they are not subject to personal liability as long as full disclosure of all material facts has been made to the shareholders, and shareholders have approved the transaction and have appraisal rights.¹⁵⁶

¹⁵¹ *Id.*

¹⁵² *See infra* Part V.

¹⁵³ 1 ALI CORPORATE GOVERNANCE PROJECT, *supra* note 1, § 6.01 cmt. e, at 395.

¹⁵⁴ *Id.* at 395-96.

¹⁵⁵ *Id.* at 396.

¹⁵⁶ *Id.*

4. Action in Good Faith and Absence of Interest

The *Project* says that “[a]ction in good faith requires that directors not act in knowing violation of substantive rules of law (including substantive rules of law applicable to take-overs).”¹⁵⁷

Usual and customary directors’ fees and perquisites, even if a significant portion of a director’s income, do not make the director interested in the transaction. Thus, as a general rule, outside directors will not have an interest in the transaction. If, however, “a director is to receive a substantial severance payment as a condition to action or inaction, the director might well be so interested in the outcome of the transaction as to fall outside the protection of the business judgment rule.”¹⁵⁸

5. Rational Belief that Action is in Best Interest of the Corporation

The rational belief requirement is “intended to give a much wider scope to directors’ discretion than the term ‘reasonably’.”¹⁵⁹ Thus, directors are to have a “wide ambit of discretion, not only in determining the price to be paid or received upon purchase or sale of a business, but also as to such other matters as determining the appropriate time to sell the business [and] the nature of consideration to be received”¹⁶⁰

By way of example, the *Project* says that disinterested directors may make a decision that may be more favorable to some shareholders than to others, such as a decision to negotiate a tax-free or taxable transaction.¹⁶¹

E. Illustration of Operation of Section 6.01

The *Project* contains an illustration of the operation of Section 6.01 that is based on facts similar to those in *Van Gorkom*.¹⁶² The target corporation is a publicly held corpora-

¹⁵⁷ *Id.*

¹⁵⁸ *Id.* at 397.

¹⁵⁹ *Id.*

¹⁶⁰ *Id.*

¹⁶¹ *Id.*

¹⁶² *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985).

tion whose stock is trading in the \$15-\$20 range. A, the chief executive of the target, asks B, the chief financial officer, to prepare an analysis of the potential sales price of the target. B had available a recent valuation of the target's substantial timber assets. B concluded that a range of \$25-\$30 per share was acceptable. The premium was similar to that paid in acquisitions of comparable companies.

A negotiated a merger agreement with an acquiring corporation calling for a price of \$27.50 per share. The merger agreement obligated the target not to shop the deal. A presented the proposed merger agreement to the target's directors, who approved the transaction after a single long meeting relying on the appraisal and on prices paid for comparable companies, but without reading the merger agreement. After full disclosure to the shareholders of the material facts, the shareholders approved the transaction as required by law. Shareholders who did not vote for the transaction sued to have the directors held liable for selling the target for an inadequate price. The example holds that the directors' action in approving the merger agreement is protected by the business judgment rule.¹⁶³

There are several salient differences between this example and the facts in *Van Gorkom*, where the Delaware Supreme Court held that the target's board members did not receive the protection of the business judgment rule because they were grossly negligent in failing to inform themselves.¹⁶⁴ First, in *Van Gorkom*, the Chief Executive Officer negotiated the merger price with the acquiror without the full participation of his chief financial officer.¹⁶⁵ Second, the board in *Van Gorkom* relied on the Chief Executive Officer without diligently considering all aspects of the proposed transaction, including how the Chief Executive Officer arrived at the price.¹⁶⁶ Third, the board failed to disclose all of the relevant facts to the shareholders.¹⁶⁷

¹⁶³ 1 ALI CORPORATE GOVERNANCE PROJECT, *supra* note 1, § 6.01 cmt. f, illus. 1, at 399.

¹⁶⁴ *Van Gorkom*, 488 A.2d at 874.

¹⁶⁵ *Id.* at 877.

¹⁶⁶ *Id.*

¹⁶⁷ *Smith v. Van Gorkom*, 488 A.2d 858, 890-93 (Del. 1985).

F. The General Appraisal Remedy

1. Introduction

This section outlines in general scope the appraisal rules contained in Sections 7.21 through 7.25. Under these rules a shareholder who has the right to vote on a merger, acquisition or other transaction in control and who votes against the proposed transaction may elect to have the value of her shares appraised in a court proceeding. In such case, in lieu of receiving the consideration specified in the merger or acquisition documents, the shareholder receives a cash payment in the amount of the value determined by the appraisal court.

The *Project* points out that although the appraisal remedy has been criticized as being too restrictive, others argue that a more liberalized remedy would invite non-meritorious litigation.¹⁶⁸ One study of the appraisal process found that between 1972 and 1981 there were over 16,000 mergers but only approximately 20 reported state court appraisal decisions.¹⁶⁹

The Reporter's Notes¹⁷⁰ say that the most likely explanation for the limited use of appraisal proceedings is that the "remedy is costly, while the outcomes remain very uncertain."¹⁷¹ This uncertainty is illustrated in the appraisal proceedings in *Cede & Co. v. Technicolor, Inc.*¹⁷² There the appraisal court found that the value of a target's shares acquired in a second step freezeout merger was \$21.60 even though the acquiror had paid \$23.00 for the target's shares in a tender offer that took place just before the freezeout merger.

The Reporter's Notes say that the low rate of utilization of the appraisal remedy creates an "obvious incentive for those in control of the corporation to offer less than fair value."¹⁷³ The

¹⁶⁸ 2 ALI CORPORATE GOVERNANCE PROJECT, *supra* note 1, introductory note, at 294.

¹⁶⁹ *Id.* (citing Joel Seligman, *Reappraising the Appraisal Remedy*, 52 GEO. WASH. L. REV. 829, 829 n.3 (1984)).

¹⁷⁰ An introductory note points out that the Reporter's Notes are those of the reporters and not the American Law Institute. 1 ALI CORPORATE GOVERNANCE PROJECT, *supra* note 1, at XXV.

¹⁷¹ 2 ALI CORPORATE GOVERNANCE PROJECT, *supra* note 1, reporter's note 3, at 298.

¹⁷² *Cede & Co. v. Technicolor, Inc.*, No. Civ. A. 7129, 1990 WL 161084 (Del. Ch. Oct. 19, 1990).

¹⁷³ 2 ALI CORPORATE GOVERNANCE PROJECT, *supra* note 1, reporter's note 3,

Notes speculate that it may be for this reason that in *Weinberger v. UOP, Inc.*,¹⁷⁴ the Delaware Supreme Court said in the context of a freezeout merger that the appraisal remedy is not likely to be adequate "where fraud, misrepresentation, self-dealing, deliberate waste of corporate assets, or gross and palpable overreaching are involved."¹⁷⁵

The *Project* goes on to say that the exclusivity of the appraisal remedy can be justified only if "(i) the procedures applicable to the appraisal remedy minimize those barriers that now inhibit its exercise by eligible shareholders, and (ii) some limited exceptions to exclusivity are recognized in those circumstances where conflicts of interest are most apparent."¹⁷⁶

The *Project* explains that the approach taken in Sections 7.21 through 7.25 reduces the transaction costs applicable to appraisal proceedings by (1) reducing the required procedural steps; (2) establishing procedures for informing shareholders of the "availability of a realistic means" by which to contest the corporation's estimate of fair market value; (3) providing a mechanism for the use of common counsel by the dissenting shareholders; and (4) assuring early payments to dissenters of the estimated fair market value, with a fair interest rate.¹⁷⁷ The *Project* goes on to say that if a "low cost, simple, and fair remedy can be provided in a centralized forum, there is less reason to permit multiple actions to be filed in different jurisdictions seeking to enjoin the contemplated transaction."¹⁷⁸

2. Transactions in Control Giving Rise to Appraisal Rights

Section 7.21 provides that a shareholder should be entitled on demand to be paid the fair value of his or her shares on the occurrence of, inter alia, the following four types of acquisitions:

- (1) both direct and subsidiary mergers, consolidations, issuances by an acquiring corporation of its stock for substantial assets or stock of a target, and mandatory share exchanges, (i.e.,

at 298.

¹⁷⁴ 457 A.2d 701 (Del. 1983).

¹⁷⁵ *Id.* at 714.

¹⁷⁶ 2 ALI CORPORATE GOVERNANCE PROJECT, *supra* note 1, introductory note, at 295.

¹⁷⁷ *Id.* at 295-96.

¹⁷⁸ *Id.* at 296.

a business combination), unless the shareholders of the target or acquiring corporation own proportionately at least 60% of the stock of the acquiring corporation after the transaction,¹⁷⁹

(2) all types of freezeout mergers and similar transactions;¹⁸⁰

(3) a sale or disposition of substantial assets that leaves the target without a significant continuing business, unless the sale is in the ordinary course or is for cash or cash equivalents and the target is liquidated.¹⁸¹

(4) a management buyout under Section 5.15 effected through a sale of any amount of the target's assets, unless the market test procedures specified in Section 5.15(b) are followed.¹⁸²

Thus, Section 7.21 encompasses a "range of transactions that would normally constitute a 'transaction in control'"¹⁸³

The Reporter's Notes explain that a prior draft of the *Project* provided for appraisal rights in a "going private" transaction in which a person acquired a controlling interest in the target and as a result of the acquisition, stock of the target is no longer held by at least 300 shareholders or the target ceased to be a listed company. This rule, which did not apply to tender offers for all of a target's shares, was rejected by the ALI.¹⁸⁴

The balance of this section of this article focuses principally on appraisal rights in arm's length mergers and acquisitions.

In a merger, consolidation or issuance of stock for assets, the shareholders of both the acquiring and target corporations are entitled to the appraisal remedy, unless the shareholders of the acquiror (and presumably the shareholders of the target) continue to own after the transaction at least 60% of the outstanding stock of the surviving corporation.¹⁸⁵ Thus, if this 60% continuity of stock interest test is met the acquiror's (or target's) shareholders do not have appraisal rights.

On an issuance of stock of the acquiring corporation for stock of the target in an exchange offer (such as in a stock for stock tax-free (B) reorganization under Section 368(a)(1)(B) of the Internal Revenue Code), the shareholders of the target do not

¹⁷⁹ *Id.* § 7.21(a).

¹⁸⁰ *Id.* § 7.21(b).

¹⁸¹ *Id.* § 7.21(c).

¹⁸² *Id.* § 7.21 cmt. c, at 306, and § 7.21(c)(1).

¹⁸³ *Id.* at 302.

¹⁸⁴ *Id.* reporter's note 3, at 312-13.

¹⁸⁵ *Id.* § 7.21 cmt. c, at 301-02.

have appraisal rights. Furthermore, the shareholders of the acquiring corporation have appraisal rights only if the acquiror issues more than 40% of its voting stock to the target's shareholders.¹⁸⁶ If more than 40% of the acquiror's stock is issued, the 60% continuity requirement is not satisfied.

In a triangular (subsidiary) merger a target and a subsidiary (acquiring sub) of an acquiring parent merge, with either the target or the acquiring sub surviving. If the target's shareholders receive stock of the acquiring parent, the shareholders of the acquiring parent have dissenters' rights, unless the acquiring parent issues less than 40% of its voting stock in the merger.¹⁸⁷ If the acquiring parent does not issue any of its stock, the shareholders of the acquiring parent have no appraisal rights. The target's shareholders have dissenters' rights in such a transaction, unless the target's shareholders end up owning at least 60% of the stock of the acquiring parent.

The *Project* explains that Section 7.21(a) is intended to encompass "approximately the same functional reach as the 'de facto' merger doctrine"¹⁸⁸ The *Project* follows the lead of California and Ohio, which in essence have codified the de facto merger doctrine, and reject the equal dignity rule of Delaware.¹⁸⁹ Under Sections 251 and 263 of the Delaware General Corporation Law, the shareholders of the acquiring parent in a triangular merger do not have the right to vote or the right of appraisal, even though stock of the acquiring parent is used as the merger consideration.¹⁹⁰ On the other hand, under Sections 1201 and 1300 of the California Corporations Code, the shareholders of such an acquiring parent generally have the right to vote and to dissent.¹⁹¹

Under Section 1.38 of the *Project*, a transaction in control does not take place if the acquiror's shareholders retain a 75% continuity of interest in the acquiror. In such case, the acquiror's shareholders do not have a right to vote on the trans-

¹⁸⁶ *Id.* at 304.

¹⁸⁷ *Id.* at 302.

¹⁸⁸ *Id.*

¹⁸⁹ *Id.* at 303.

¹⁹⁰ 2 ERNEST L. FOLK III, RODMAN WARD, JR. & EDWARD P. WELCH, FOLK ON THE DELAWARE GENERAL CORPORATION LAW, §§ 251.2.5 and 263 (3d ed. 1995) [hereinafter *Folk on Delaware*]. See also DEL. CODE ANN. tit 8, §§ 251 and 263 (1991 & Supp. 1994).

¹⁹¹ CAL. CORP. CODE §§ 1201 and 1300 (West Supp. 1996).

action as provided in Section 6.01(b). Section 7.21 denies appraisal rights to the acquiror's shareholders if they retain a 60% continuity. Thus, there is a 75% continuity requirement for denial of the vote and a 60% continuity requirement for denial of appraisal rights. The operation of these two continuity rules is illustrated as follows:

Acquiror's Voting Stock Issued to Target's Shareholders	Acquiror's Shareholders' Vote	Acquiror's Shareholders' Appraisal
10%	No	No
24%	No	No
26%	Yes	No
39%	Yes	No
41%	Yes	Yes

Most states, have a single continuity standard for both voting and appraisal. For example, Delaware has a 20% continuity standard requirement for both voting and appraisal.¹⁹²

As explained above, Section 7.21(c)(2) provides for appraisal rights for a target's shareholders on a sale of the target's assets that leaves the target without a significant continuing business, unless the sale is in the ordinary course of business or is for cash or cash equivalents and the target is liquidated. Thus, appraisal rights arise in various types of arm's length mergers, stock acquisitions and asset acquisitions.

The *Project* rejects the exclusion from the appraisal remedy for publicly traded shares such as that contained in Section 262(b)(1) of the Delaware General Corporation Law (the "market exclusion").¹⁹³ The *Project* explains that 23 jurisdictions have adopted similar provisions.¹⁹⁴ The *Project* gives the following three reasons for rejecting the market exclusion: (1) "the market's valuation may reflect the prospect of future adverse

¹⁹² See DEL. CODE ANN. tit. 8, §§ 251 and 263 (1991 & Supp. 1994).

¹⁹³ See DEL. CODE ANN. tit. 8, § 262(b)(1) (Supp. 1994).

¹⁹⁴ 2 ALI CORPORATE GOVERNANCE PROJECT, *supra* note 1, § 7.21 cmt. d, at 309.

impact or other disadvantage to the minority shareholders;¹⁹⁵ (2) "management may possess material, non-public information about the corporation;"¹⁹⁶ and (3) if the "appraisal remedy is unavailable, it can hardly be exclusive, and thus plaintiffs will pursue injunctive or other equitable remedies."¹⁹⁷

3. General Procedural Requirements

Section 7.23 sets out the procedural requirements relating to the appraisal remedy. Under Section 7.23(a), a corporation that proposes to engage in a transaction giving rise to appraisal rights is required to give notice of such rights to the shareholders, describe the method of exercising the right, disclose material facts concerning the transaction, provide financial statements for the corporation, and provide a reasonable means for shareholders to "easily and effectively indicate their election to dissent."¹⁹⁸ Under Section 7.23(b), shareholders are to be given a reasonable means of indicating their dissent.

Under Section 7.23(c), promptly after the transaction, the corporation is required to pay in cash to the dissenting shareholders the amount the corporation determines to be a reasonable estimate of the fair value of the shares, plus interest.

Under Section 7.23(d), the costs and expenses are to be assessed or apportioned as the court deems equitable, subject to the following exceptions. First, if the corporation does not make the payment required by Section 7.23(c) within 30 days after the consummation of the transaction or the tendering of the shares, if later, or if the amount paid is materially less than the amount ultimately determined to be the fair value, then the corporation is responsible for all fees and expenses. The corporation's fees and expenses will be assessed against the dissenting shareholder only if the shareholder's action was "arbitrary, vexatious, or not in good faith."¹⁹⁹

Under Section 7.23(e) interest is to be paid from the time of the transaction.

¹⁹⁵ *Id.* at 309.

¹⁹⁶ *Id.* at 310.

¹⁹⁷ *Id.*

¹⁹⁸ *Id.* at § 7.23(a)(iv).

¹⁹⁹ *Id.* at § 7.23(d).

Section 7.23(f) provides for the litigation of appraisal proceedings in a consolidated proceeding, with the court having the right to appoint lead counsel for the dissenters.

4. Standards for Determining Fair Value

a. In General

Section 7.22, which sets forth the standards for determining "fair value" in an appraisal proceeding, provides that such value is to be determined "without any discount for minority status or, absent extraordinary circumstances, lack of marketability" and, except as provided in Sections 7.22(b) and (c), "should be determined using customary valuation concepts and techniques generally employed in the relevant securities and financial markets for similar businesses in the context of the transaction giving rise to appraisal."²⁰⁰ The *Project* explains that Section 7.22(a) follows the law in New York and Delaware in requiring that the court use the "relevant financial valuation techniques generally employed in the financial community."²⁰¹

In *Weinberger v. UOP, Inc.*,²⁰² the Delaware Supreme Court held that in determining fair value an appraisal court is to take into account all relevant factors which include modern valuation techniques such as the discounted cash flow (DCF) technique used by the plaintiff's expert. This DCF technique is a four-step process that involves first, an estimate of the free cash flows from operations for some foreseeable or horizon period; second, an estimate of a terminal or residual value at the end of the horizon period; and third, a determination of the appropriate cost of capital or discount rate for the business. Finally, the free cash flows and terminal value are then discounted at the cost of capital to determine the present value or fair market value of the business.²⁰³

²⁰⁰ *Id.* at § 7.22(a).

²⁰¹ *Id.* cmt. a, at 315-16.

²⁰² *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983).

²⁰³ 2 ALI CORPORATE GOVERNANCE PROJECT, *supra* note 1, reporter's note 1, at 330.

b. Fair Value in Arm's Length Transactions

Section 7.22(b) provides an exception to the above rule for arm's length business combinations, that is, transactions that are not (1) management buyouts under Section 5.15, (2) freeze-outs under Section 5.10, or (3) freezeouts involving a controlling shareholder under Section 7.25. These three transactions are referred to here as interested-party acquisitions.

The *Project* explains that in an arm's length acquisition, the aggregate price accepted by the target's directors "should be presumed to represent the fair value of the corporation, or of the assets sold in the case of an asset sale, unless the plaintiff can prove otherwise by clear and convincing evidence."²⁰⁴ The *Project* further says that in third party mergers, the "prevailing valuation approaches in the relevant market should govern,"²⁰⁵ and "the price negotiated by the board [is to be] presumptive evidence of fair value."²⁰⁶ Thus, the presumption given to the value of the transaction determined by the board would not be overcome by evidence from investment bankers concerning the hypothetical break-up value of the firm, because such evidence is too speculative to amount to clear and convincing evidence.²⁰⁷

This presumption is given for third party transactions because "management generally has every incentive to obtain the highest possible price"²⁰⁸ By placing the burden on the dissenters, Section 7.22(b) is consistent with the business judgment rule and will discourage nuisance litigation.²⁰⁹ The presumption in Section 7.22(b) should not, however, apply where there is a "substantial possibility of a conflict of interest,"²¹⁰ such as an acquisition requiring an allocation of consideration among different classes of shares, or if the managers of the target receive long-term employment contracts from an acquiror that did not have the highest bid.²¹¹

²⁰⁴ *Id.* § 7.22(b).

²⁰⁵ *Id.* § 7.22 cmt. a, at 316.

²⁰⁶ *Id.* cmt. c, at 316.

²⁰⁷ *Id.* illus. 1, at 317.

²⁰⁸ *Id.* cmt. c, at 316.

²⁰⁹ *Id.* at 316-17.

²¹⁰ *Id.* at 317.

²¹¹ *Id.* illus. 2 and 3, at 317-18.

The *Project* explains that the purpose of the appraisal remedy is to allow shareholders to “police conflicts of interest that may arise in connection with the sale or disposition of the firm,” and “[i]n the absence of a conflict of interest,” there is little justification for upsetting the bargain reached by the selling and purchasing firms.²¹² The *Project* says that the presumption in Section 7.22(b) “will generally be overcome only when there is evidence of passivity on the part of the board or of an incentive or interest that caused it not to bargain vigorously.”²¹³

The *Project* contains three illustrations of the application of the clear and convincing proof standard in arm’s length transactions. In the first example, the acquiror and target negotiate an all stock merger at an exchange ratio reflecting the current trading value of the stock of each corporation. Even though investment bankers could testify that the break-up value of each of the corporations is substantially greater than the current trading value, this testimony would not constitute clear and convincing evidence needed to overcome the presumption set forth in Section 7.22(b) “that the aggregate price accepted by the board of directors of the subject corporation . . . represent[s] fair value of the corporation”²¹⁴

On the other hand, evidence that a target’s senior executives received long-term employment contracts with a significant increase in compensation from a successful but low bidder could constitute “clear and convincing evidence sufficient to overcome the presumption [of fair value] created by Section 7.22(b).”²¹⁵

5. Exclusivity of Appraisal Remedy

a. In General

As set out more fully below, pursuant to Section 7.24, appraisal is generally the exclusive remedy in arm’s length mergers and acquisitions.²¹⁶ Appraisal is not, however, the ex-

²¹² *Id.* cmt. c, at 317.

²¹³ *Id.* cmt. d, at 320 (citing *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985)).

²¹⁴ *Id.* § 7.22(b).

²¹⁵ *Id.* § 7.22 cmt. c, illus. 2, at 318.

²¹⁶ See *infra* Part III.F.5.b.

clusive remedy in management buyouts²¹⁷ and in non-majority control freezeouts.²¹⁸ In certain cases, appraisal may be the exclusive remedy under Section 7.25 in majority-control freezeouts.²¹⁹ Thus, an "injunction remedy in which issues of substantive fairness can be litigated"²²⁰ is only permitted in "interested combinations" (i.e., management buyouts and non-Section 7.25 freezeouts) where "the self-interest of a controlling shareholder, directors, or principal senior executives is [fundamentally] in conflict with that of the minority shareholders"²²¹

b. Exclusivity of Appraisal Proceedings for Arm's Length Mergers and Acquisitions

Under Section 7.21, the appraisal remedy is available to the target's shareholders in all forms of arm's length mergers and acquisitions discussed in Part III, unless such shareholders own after the transaction at least 60% of the outstanding stock of the acquiror.²²² Also, under Section 7.21(a), appraisal is available to the shareholders of the acquiring corporation unless they continue to own at least 60% of the outstanding stock of the acquiror after the transaction.²²³ Thus, for example, if the shareholders of an acquiror in a merger end up with a 60% or greater interest in the surviving firm, such shareholders do not have appraisal rights. As pointed out in Part III.F.2, this 60% continuity exception to appraisal rights is less restrictive than the 75% continuity exception to voting rights in a transaction in control under Section 1.38(b)(3). Consequently, if the shareholders of an acquiror end up with less than 75% but more than 60% of the stock of the surviving firm, such shareholders have the right to vote but not the right to dissent.

Section 7.24(a) provides that, if the following three conditions are satisfied, this appraisal right in an arm's length transaction is the exclusive remedy to challenge an arm's length merger

²¹⁷ See *infra* Part IV.C.3.

²¹⁸ See *infra* Part VII.B.4.c.

²¹⁹ See *infra* Part VII.C.2.c.

²²⁰ 2 ALI CORPORATE GOVERNANCE PROJECT, *supra* note 1, introductory note, at 296.

²²¹ *Id.*

²²² See *supra* Parts III.F.1-2.

²²³ See *supra* Part III.F.2.

and acquisition. First, the shareholders who are entitled to authorize the transaction must receive disclosure concerning the transaction.²²⁴ Second, the transaction must be approved pursuant to law and the corporation's charter documents.²²⁵ Third, the shareholders who are entitled to vote on the transaction, but do not, must be entitled to an appraisal remedy consistent with the principles embodied in Sections 7.22 and 7.23.²²⁶

Under Section 7.24(b), the challenging party has the burden of proving failure to comply with the above conditions.

Under Section 7.24(c), if the disclosure and legality conditions are satisfied, but the appraisal right condition is not, the transaction may be challenged on the ground that it constitutes a waste of corporate assets.

Under Section 7.24(d), the availability of an appraisal remedy does not preclude an action against a director or controlling shareholder for a violation of the fair dealing provisions of the *Project*. The *Project* explains the rationale of Section 7.24 as follows: "[I]n the case of a simple arm's length combination, if shareholders have an appropriate appraisal remedy, a parallel injunctive proceeding has little additional to offer."²²⁷

G. Application to the Time-Warner Transaction of the Delaware and ALI Arm's Length Merger Rules Regarding Director Action and Shareholder Voting and Appraisal Rights

1. Description of the Originally Proposed Time-Warner Merger

The originally proposed Time-Warner merger was structured as a reverse subsidiary stock merger, with Time-Sub, a subsidiary of Time merging into Warner.²²⁸ Pursuant to the merger, the shareholders of Warner were to receive in exchange for their Warner stock (which was to be cancelled) common stock of

²²⁴ 2 ALI CORPORATE GOVERNANCE PROJECT, *supra* note 1, § 7.24(a)(1).

²²⁵ *Id.* at § 7.24(a)(2).

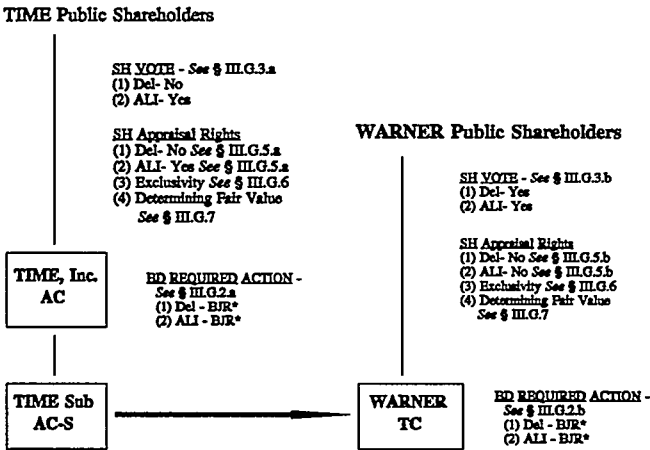
²²⁶ *Id.* at § 7.24(a)(3).

²²⁷ *Id.* § 7.24 cmt. a, at 349.

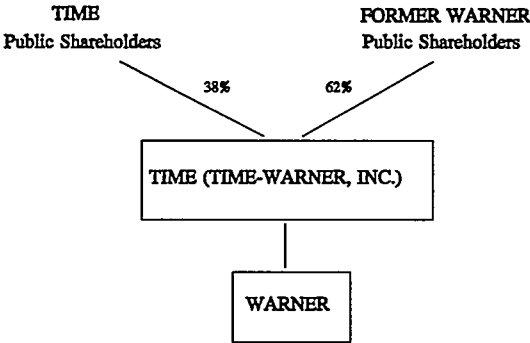
²²⁸ Time-Warner Joint Proxy Statement and Time Prospectus (May 22, 1989).

Time amounting to approximately 62% of Time's outstanding stock after the merger, and the common stock of Time-Sub held by Time was to be converted into Warner stock. Consequently, upon completion of the transaction (1) the former Warner shareholders would have owned 62% and the former Time shareholders would have owned 38% of the parent company, Time, which would have had its name changed to Time-Warner, and (2) Warner would have been a subsidiary of the new Time-Warner. The transaction is diagrammed in Chart A.

**CHART - A
TIME-WARNER MERGER
ORIGINAL**



WHEN DUST SETTLES



* BJR means business judgment rule

In addition to the above structure, Time and Warner entered into a Share Exchange Agreement which provided for the issuance by Warner of approximately 10% of its stock to Time in exchange for approximately 12% of Time's stock. The Share

Exchange Agreement would have been triggered upon the happening of certain events, such as a hostile tender offer by a third party for either Time or Warner. The purpose of the Share Exchange Agreement was to deter another party from attempting to take over either Time or Warner. Thus, the Share Exchange Agreement was a defensive tactic designed to lock-up the Time-Warner merger.

2. Required Actions and Standards Governing Actions of Time's and Warner's Boards of Directors

In the following analysis, each Board's actions will be examined under Delaware law and then under the ALI Rules. The same analysis pattern will apply each time the Time-Warner transaction and the actions of the various parties, including Boards of Directors and shareholders, are considered.

a. Time's Board

Since the transaction was structured as a reverse subsidiary merger, Time was not a "constituent" corporation under Section 251 of the Delaware General Corporation Law (relating to mergers),²²⁹ and consequently, Time's Board was not required pursuant to that provision to make a recommendation to its shareholders regarding the merger transaction. However, under the general duty of management under Section 141(a),²³⁰ Time's Board was required to approve the transaction.

The standard business judgment rule governed the director's actions, including their actions in entering the lock-up. The Delaware Supreme Court specifically held in *Paramount Communications, Inc. v. Time, Inc.*²³¹ that Time's board was not subject to "Revlon duties"²³² in negotiating the merger with Warner. Consequently, the business judgment rule was applicable. *Revlon* duties would have applied if the transaction had

²²⁹ See DEL. CODE ANN. tit. 8, § 251 (1991 & Supp. 1994).

²³⁰ DEL. CODE ANN. tit. 8, § 141(a) (1991).

²³¹ 571 A.2d 1140 (Del. 1990).

²³² *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986).

involved a change of control of Time. In such case, Time would have been required to "seek the transaction offering the best value reasonably available to the stockholders."²³³ The court held that *Revlon* duties would have applied if "in negotiating with Warner, [Time's board had] made the dissolution or break-up of the corporate entity inevitable, as was the case in *Revlon*."²³⁴

Other cases, including *Crouse Hinds*,²³⁵ *Buffalo Forge*²³⁶ and *Cottel*,²³⁷ have also applied the business judgment rule in evaluating lock-ups associated with arm's length merger agreements.²³⁸

Under the ALI rules, the originally proposed *Time-Warner* merger would have been a transaction in control under Section 1.38(a) of the *Project*. The transaction did not come within the 75% continuity exception of Section 1.38(b)(3). Consequently, under Section 6.01(a), the transaction would have required the approval of the board of directors of Time. And, as provided in Section 6.01(a), the business judgment rule of Section 4.01(c) would have governed the actions of the directors. The *Project* does not take a position on the use of lock-ups, such as the share exchange agreement.²³⁹

b. Warner's Board

Under Delaware law, Warner was a constituent corporation under Section 251(c) of the Delaware General Corporation Law, and as a consequence, in order for the merger agreement to be presented to the Warner shareholders for their consideration,

²³³ *Paramount Comm., Inc. v. Time, Inc.*, 637 A.2d 34 (Del. 1993).

²³⁴ *Time-Warner*, 571 A.2d at 1150.

²³⁵ *Crouse-Hinds Co. v. InterNorth, Inc.*, 634 F.2d 690 (2d Cir. 1980).

²³⁶ *Buffalo Forge Co. v. Ogden Corp.*, 717 F.2d 757 (2d Cir. 1983), *cert. denied*, 464 U.S. 1018 (1983).

²³⁷ *Cottle v. Storer Communicaton, Inc.*, 849 F.2d 570 (11th Cir. 1988).

²³⁸ 1 ALI CORPORATE GOVERNANCE PROJECT, *supra* note 1, reporter's note 8, at 404.

²³⁹ *Id.* § 6.01 cmt. d, at 393.

Section 251(b) required that the Warner board affirmatively approve the transaction.²⁴⁰

The actions by the Warner directors were governed by the business judgment rule as illustrated in the *Van Gorkom*²⁴¹ decision. Also, the Share Exchange Agreement was subject to the business judgment rule.

Under the ALI rules, the transaction would have been a transaction in control with respect to Warner under Section 1.38(a) of the *Project*, and as a consequence, approval of the transaction by the Warner board of directors would have been required under Section 6.01(a).

Section 6.01(a) provides that the business judgment rule of Section 4.01(c) applies to the director's action. Thus, the *Project* follows the *Van Gorkom* principles of Delaware law in applying the business judgment rule to the Warner board.²⁴² The *Project* clarifies, however, that there is no requirement for Warner's directors to determine a single "intrinsic value" as suggested in *Van Gorkom*.²⁴³

The *Project* also makes it clear that the target's directors do not have a duty to auction the company,²⁴⁴ and the directors can give an auction ending lock-up.²⁴⁵ Further, the *Project* clarifies that the directors may, consistent with the business judgment rule, reject the offer.²⁴⁶

3. The Right of Shareholders to Vote

a. Time's Shareholders

Under Delaware law, the Time shareholders did not have a right to vote because Time was not a constituent corporation under Section 251(c) of the Delaware General Corporation Law.

²⁴⁰ See DEL. CODE ANN. tit. 8, § 251(b) (Supp. 1994).

²⁴¹ *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985).

²⁴² 1 ALI CORPORATE GOVERNANCE PROJECT, *supra* note 1, § 6.01 cmt. e(1), at 395.

²⁴³ *Id.*

²⁴⁴ *Id.*

²⁴⁵ *Id.*

²⁴⁶ 2 ALI CORPORATE GOVERNANCE PROJECT, *supra* note 1, § 7.24 cmt. c(3), illus. 2, at 356.

This is because in a triangular merger under Delaware law, the acquiring parent corporation is not a constituent corporation under Section 251(c).²⁴⁷ However, the Time shareholders were given the right to vote pursuant to the New York Stock Exchange Rules.²⁴⁸ Under these rules, the shareholders of an acquiring firm have the right to vote if the common stock to be issued in the transaction will have voting power equal to or in excess of 20% of the voting power outstanding before the issuance or the number of shares of common stock to be issued in the transaction is equal to or in excess of 20% of the number of shares of common stock outstanding before the issuance.²⁴⁹

Under the ALI rules, the proposed merger would have been a transaction in control under Section 1.38(a) of the *Project*. The transaction would not have been excepted under the 75% continuity test of Section 1.38(b)(3) because the Time shareholders did not retain a 75% continuity of interest in Time. Their interest would have been diluted from 100% of Time shares to 38% of Time-Warner shares.

As a consequence of the transaction constituting a transaction in control with respect to Time, the Time shareholders would have had the right to vote under Section 6.01(b). This result illustrates the codification by the *Project* of the de facto merger doctrine.

b. Warner's Shareholders

Under Section 251(c) of the Delaware General Corporation Law, Warner was a constituent corporation, and, consequently, the Warner shareholders had the right to vote.

Under the ALI rules, the merger would have been a transaction in control with respect to Warner under Section 1.38(a) of the *Project*, and, therefore, under Section 6.01(b), the Warner shareholders would have had the right to vote.

²⁴⁷ *Folk on Delaware*, *supra* note 190, at 17.

²⁴⁸ New York Stock Exchange Rules, Section 312, (Relating to Shareholder Approval Policy).

²⁴⁹ *Id.* at § 312.03(c).

The Warner shareholders apparently would not have had the right to vote if they had received 75% or more, rather than only 62%, of the resulting company, Time-Warner. In such an event, the 75% continuity of interest exception of Section 1.38(b)(3) would have applied. Clearly, this exception would have applied if Warner had been the surviving corporation and the 75% continuity requirement had been satisfied. A close reading of Section 1.38(b) seems to indicate that the continuity exception applies both when the acquiror's shareholders satisfy the 75% continuity test and when the target's shareholders satisfy that test. The discussion in the *Project* does not appear to address this issue.

4. Right of Shareholders to Appraisal

This and succeeding sections focus on the dissenters' rights provisions of the *Project* and Delaware law in the context of the Time-Warner proposed arm's length merger. Section III.G.5 discusses the rules governing the determination of whether the shareholders were entitled to dissenters' or appraisal rights. Section III.G.6 addresses whether appraisal would have been the exclusive remedy, and Section III.G.7 deals with the determination of fair value in an appraisal proceeding regarding an arm's length transaction.

5. Right to Appraisal in Originally Proposed Merger

a. Time's Shareholders

In the originally proposed arm's length merger, a subsidiary of Time was going to merge into Warner with the common shareholders of Warner receiving 62% of the stock of Time.²⁵⁰

No vote was required under Delaware law by the Time shareholders, even though they would have owned only 38% of the surviving corporation. This was because Time was not a constituent corporation as specified in Section 251(c) of the Delaware General Corporation Law.²⁵¹ Since Time was not a

²⁵⁰ See *supra* Part III.G.1.

²⁵¹ *Folk on Delaware*, *supra* note 190, at 17.

constituent corporation, the shareholders of Time did not have appraisal rights under Section 262 of the Delaware General Corporation Law.

If Warner had merged directly into Time, Time would have been a constituent corporation under Section 251(c), and the Time shareholders would have had the right to vote. Time also would have been a constituent corporation under Section 262(b) of the Delaware General Corporation Law, and but for the fact that Time's shares were listed on a stock exchange and, therefore, excluded from appraisal by Section 262(b)(1), Time's shareholders also would have had the right to appraisal. The New York Stock Exchange rules did, however, require a vote of the Time shareholders, but a right of appraisal under Delaware law did not follow this right to vote.²⁵²

Since the shareholders of Time ended up with less than 60% of the surviving firm, the shareholders of Time would have been given appraisal rights under Section 7.21(a) of the *Project*.

There is no market exception to the appraisal right under the *Project*.

b. Warner's Shareholders

On the Warner side of the transaction, Warner was a constituent corporation under Section 251(c) of the Delaware General Corporation Law, and, consequently, its shareholders had the right to vote. Also, the shareholders would have had the right to dissent under Section 262 but for the market exception under Section 262(b). Under this exception, since the Warner shares were traded on the New York Stock Exchange and they were being exchanged for Time shares that were going to be traded on that exchange, the Warner shareholders were not given appraisal rights.

In the originally proposed merger, the Warner shareholders apparently would not have had an appraisal right under Section 7.21(a) of the *Project*. This is because the Warner shareholders would have owned at least 60% of the stock of the

²⁵² See *supra* note 248 and accompanying text.

surviving corporation.²⁵³ Clearly, if Warner had been the acquiring corporation, the Warner shareholders would not have had appraisal rights because they would have continued to own at least 60% of Warner.

6. Exclusivity of Appraisal Proceedings in Originally Proposed Merger

a. Time's Shareholders

As indicated in Part III.G.5.a, the shareholders of Time did not have the right of appraisal in the originally proposed merger because Time was not a constituent corporation under Section 262(b) of the Delaware General Corporation Law.

Presumably, under the Delaware Supreme Court's decision in *Weinberger*, if the Time shareholders had appraisal rights in that transaction, appraisal would have been the exclusive remedy because there was no "fraud, misrepresentation, self-dealing, deliberate waste of corporate assets, or gross palpable overreaching"²⁵⁴ Thus, in the originally proposed merger, the shareholders of Time had no appraisal rights and also had no other rights enabling them to challenge the transaction.

However, as indicated in Part III.G.5.a, under Section 7.21 of the *Project*, Time's shareholders would have had appraisal rights in the originally proposed merger.

Under Section 7.24 of the *Project*, appraisal would have been the exclusive remedy for the Time shareholders in the originally proposed merger because the transaction was not a minority-controlled freezeout subject to Section 5.10, a management buyout subject to Section 5.15, or a majority controlled freezeout subject to Section 7.25. This conclusion is predicated on the assumption that none of the directors or executive officers of Time had an "interest" in the transaction so as to cause the transaction to be subject to the management buyout rules of Section 5.15.²⁵⁵ The mere payment of a post acquisition salary

²⁵³ See *infra* Part III.F.2.

²⁵⁴ *Weinberger v. UOP, Inc.*, 457 A.2d 701, 714 (Del. 1983). See also *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345 (Del. 1993).

²⁵⁵ See *infra* Part IV.

to an executive of either Time or Warner would not in and of itself cause the transaction to fall within Section 5.15.²⁵⁶ This point is made by the following illustration from the *Project*:

A, who is the chief executive officer of X Corporation, is approached by Y Corporation with a proposal that Y Corporation acquire X Corporation by a merger in which Y Corporation will issue two shares of its common stock for each outstanding share of X Corporation common stock. The relationship between the parties is not such that the merger would be subject to § 5.10, § 5.15, or § 7.25. Y Corporation indicates that it intends to enter into an employment contract substantially increasing A's rate of compensation following the acquisition. If these facts are disclosed to the board and the shareholders and the transaction otherwise satisfies the requirements of § 7.24(a)(1)-(3), the transaction is not subject to being set aside.²⁵⁷

The conclusion reached in the above illustration would not apply in the Time-Warner acquisition if an executive officer or director of Time had received an investment interest in the surviving company (other than an investment interest received in the capacity of a shareholder and on the same basis as other shareholders). In such case, such an investment interest would constitute an interest for purposes of Section 5.15 and would cause the transaction to be a management buyout in which case appraisal would not be the exclusive remedy.

The *Project* also contains an illustration, based on the *Van Gorkom* decision, that demonstrates that even in a situation where the directors breach their duty of care and are not protected by the business judgment rule, appraisal is the exclusive remedy.²⁵⁸

²⁵⁶ *Id.*

²⁵⁷ 2 ALI CORPORATE GOVERNANCE PROJECT, *supra* note 1, § 7.24 cmt. c(3), illus. 2, at 355-56.

²⁵⁸ *Id.* illus. 3, at 356-57.

b. Warner's Shareholders

As indicated in Section III.G.5.b, the Warner common shareholders did not have appraisal rights in the originally proposed merger because of the market exception in Section 262(b)(1) of the Delaware General Corporation Law. Under the *Weinberger* fraud, etc. standard, appraisal was apparently the only remedy, and, therefore, the Warner shareholders could not otherwise have challenged the merger.

As indicated in Section III.G.5.b, Warner shareholders apparently would not have had appraisal rights under Section 7.21 of the *Project* because they would have satisfied the 60% continuity test. Also, under Section 7.24, they would have had no other rights to challenge the merger because appraisal is the exclusive remedy.

7. Determining Fair Value of Shares in Originally Proposed Merger

As indicated above, neither the Warner shareholders nor the Time shareholders had appraisal rights under Delaware law in the originally proposed merger. However, if appraisal rights had been granted the appraisal court would have taken into account all relevant factors in determining the value of the shares including modern valuation techniques, such as the discounted cash flow model.²⁵⁹

Section 7.22 of the *Project* sets out the rules regarding determination of the fair value of shares in an appraisal proceeding. Section 7.22(a) provides that "fair value should be determined using the customary evaluation concepts and techniques generally employed in the relevant securities and financial markets for similar businesses in the context of the transaction giving rise to appraisal."²⁶⁰ Thus, the standard applied here is essentially the same as the *Weinberger* test of fair value.

Section 7.22(b) provides, however, that in an arm's length transaction, the "aggregate price accepted by the board of directors of the subject corporation should be presumed to represent

²⁵⁹ See *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983).

²⁶⁰ 2 ALI CORPORATE GOVERNANCE PROJECT, *supra* note 1, § 7.22(a).

the fair value of the corporation . . . , unless the plaintiff can prove otherwise by clear and convincing evidence."²⁶¹

In the Time-Warner transaction, the shareholders of Time, but not the shareholders of Warner, would have had appraisal rights under the ALI rules. Since the transaction was arm's length, the value determined by Time's board would presumptively be the fair market value of the Time stock, unless a plaintiff could prove otherwise by clear and convincing evidence. Presumably in the Time-Warner transaction this clear and convincing standard could not have been met. Thus, as a practical matter, even though the shareholders of Time would have been given appraisal rights, the shareholders would probably have been unsuccessful in establishing that the shares were in fact more valuable than that determined by the board of directors.

H. Observations

In *Arnold v. Society for Savings Bancorp, Inc.*,²⁶² the Supreme Court of Delaware confirmed that a target's board that negotiates a stock for stock merger with the acquiror is not required to auction the target under "*Revlon* duties."²⁶³ Consequently, the business judgment rule applies. The court concluded that *Revlon's* "enhanced scrutiny" did not apply because there was "no 'sale of or change in control' when '[c]ontrol of both [companies] remain[s] in a large, fluid, changeable and changing market.'"²⁶⁴ This is true even though the shareholders of the target were "relegated to minority status in [the acquiror]"²⁶⁵ *Arnold*, in essence, confirms the holding of the Delaware Supreme Court in *Paramount Communications, Inc. v. Time, Inc.*²⁶⁶ to the effect that *Revlon* duties did not apply to the originally negotiated merger.

²⁶¹ *Id.* § 7.22(b).

²⁶² 650 A.2d 1270 (Del. 1994).

²⁶³ *Revlon, Inc. v. MacAndrews & Forbes Holding, Inc.*, 506 A.2d 173 (Del. 1986).

²⁶⁴ *Arnold*, 650 A.2d at 1290.

²⁶⁵ *Id.*

²⁶⁶ 571 A.2d 1140 (Del. 1990).

Even though under the ALI rules, dissenting shareholders are given an appraisal right in arm's length mergers and acquisitions, as a practical matter the appraisal proceeding is unlikely to produce a price that is higher than the price paid in the transaction. Therefore, appraisal proceedings in arm's length transactions would be rare under the ALI rules.

IV. MANAGEMENT BUYOUTS

A. Introduction

Section 5.15 deals with transactions in control²⁶⁷ and tender offers in which a director or principal senior executive (director/executive) is "interested." Thus, Section 5.15 addresses management buyouts; that is, transactions in which the managers of the target are involved in gaining control of a target corporation by taking an equity position in the surviving corporation and, therefore, are "interested" in the transaction.

The term "interested" is defined in Section 1.23(a)(2) to mean "a business, financial, or familial relationship with a party to the transaction or conduct, and that relationship would reasonably be expected to affect the director's or officer's judgment with respect to the transaction or conduct in a manner adverse to the corporation."²⁶⁸ "Interest" does not include, however, "employment contracts, stock options, or other normal management remuneration incentives to continue employment with the successor corporation"²⁶⁹ However, the receipt of a "substantial severance payment as a condition to action or inaction" could cause a director or officer to be interested in the transaction.²⁷⁰

Directors or executives who resign from the target "prior to or simultaneously with the time at which they present to the corporation's board of directors their proposal for acquiring its business" are not interested.²⁷¹ If a proposal by directors/

²⁶⁷ See *supra* Part III.B.

²⁶⁸ 1 ALI CORPORATE GOVERNANCE PROJECT, *supra* note 1, § 1.23(a)(2).

²⁶⁹ *Id.* § 5.15 cmt. c(1), at 364.

²⁷⁰ *Id.* § 6.01 cmt. e(2), at 397.

²⁷¹ *Id.* § 5.15 cmt. c(1), at 364.

executives is made in response to a third party's proposal, the directors/executives are still interested.²⁷²

One study of management buyouts indicates that the equity position of management rose from an average of 6.5% in the target to an average of 24.3% in the acquiring entity.²⁷³ Many of these transactions are structured as leveraged buyouts, which are acquisitions in which most of the acquisition consideration is borrowed;²⁷⁴ however, by its terms, Section 5.15 is not limited to leveraged transactions and may, indeed, apply to a stock for stock merger.

Section 5.15(a) provides that if the directors/executives of a target are interested in a transaction in control or a tender offer that results in a transfer of control of the target to another person, then the interested directors/executives have the burden of proving that the transaction is fair to the target's shareholders. Fairness can be established by showing that the price paid is within a "range of reasonableness."²⁷⁵ This proof of fairness standard does not apply if the transfer involves a transfer by a controlling shareholder²⁷⁶ or the conditions of Section 5.15(b) are satisfied.

Section 5.15(b) provides a method for both shifting the burden of proof to the party challenging the transaction and heightening the standard of proof. The challenging party must prove that the terms of the transaction are equivalent to a waste of corporate assets. This provision only applies to transactions in control involving publicly held corporations. Section 1.42 defines the term waste of corporate assets to mean either

[1] an expenditure of corporate funds or a disposition of corporate assets for which no consideration is received in exchange and for which there is no rational business purpose, or [2] if consideration is received in exchange, the consideration the corporation receives is so inadequate in value that no person of ordinary

²⁷² *Id.* cmt. c(3), at 367.

²⁷³ *Id.* cmt. c(1), at 362.

²⁷⁴ *Id.* at 361.

²⁷⁵ *Id.* cmt. c(2), at 365.

²⁷⁶ *See infra* Part VI.

sound business judgment would deem it worth that which the corporation has paid.²⁷⁷

Thus, if the interested directors/executives successfully comply with Section 5.15(b), the challenging party has the burden of showing that the transaction was a waste of corporate assets, which is a much heavier burden than merely showing that the transaction was unfair.

To shift the burden to the challenging party and heighten the proof standard under Section 5.15(b), the following four conditions must be satisfied:

(1) *Public disclosure* of the proposed transaction [must be] made;

(2) Responsible persons who express an interest [(i.e., potential acquirors) must be] provided with *relevant information* concerning [the target] and given a *reasonable opportunity to submit a competing proposal*;

(3) [After complying with (1) and (2),] the transaction [must be] *authorized by disinterested directors . . .*; and

(4) [After disclosure of (1) the interested directors'/executives' conflict of interest²⁷⁸, and (2) the transaction,²⁷⁹] the transaction [must be] *authorized or ratified by disinterested shareholders . . .* (or, if the transaction is effected by a tender offer, the offer [must be] *accepted by disinterested shareholders*) . . .²⁸⁰

Section 5.15 does not cover a transaction in which the directors/executives simply sell a business to an acquiring corporation or purchase from a corporation a division or subsidiary. Such transactions are not transactions in control and, therefore, the normal rules in Part V of the *Project* regarding fair dealing apply to such transactions.²⁸¹

The *Project* explains that the purpose of the provisions in Section 5.15(b) is to "allow the market to operate as the primary check on the fairness of a management buyout."²⁸² The qual-

²⁷⁷ 1 ALI CORPORATE GOVERNANCE PROJECT, *supra* note 1, § 1.42.

²⁷⁸ *See id.* § 1.14(a).

²⁷⁹ *See id.* § 1.14(b).

²⁸⁰ *Id.* § 5.15(b) (emphasis added).

²⁸¹ *Id.* § 5.15 cmt. c(1), at 364.

²⁸² *Id.* cmt. b, at 360.

ity and timing of the required disclosure is dependent on the realistic needs of potential bidders. Such bidders should be given access to "the same character [of information] as that provided to [the] investment banker representing any party to the transaction."²⁸³ Also, the reasonableness of the response time will be a function of the complexity of the transaction.²⁸⁴ The interested directors/executives are not required to disclose the highest price they are willing to pay.²⁸⁵

Under Section 5.15(b)(3), it is contemplated that disinterested directors will act as an independent negotiating committee on behalf of the target and that they will select their investment banker and other advisers without the participation of the interested directors/executives.²⁸⁶

The *Project* does not appear to directly address the standard to be applied in determining whether the directors have satisfied the approval requirements of Section 5.15(b)(3). Presumably, the business judgment rule would apply in making this determination.

The *Project* indicates that under existing law, although management buyouts "have not been explicitly treated as interested transactions that would explicitly trigger a full-scale fairness review, . . . disinterested director approval of such transactions [is] not being accorded the full protection of the business judgment rule."²⁸⁷

The problem that Section 5.15 addresses is "to identify governance rules that provide reasonable assurance that the division of the gain resulting from the management buyout transaction approximates that which would be forthcoming in an arm's length transaction."²⁸⁸ The *Project* says that in a management buyout, the market for corporate control can potentially police the fairness of the transaction.²⁸⁹ For this reason, Section 5.15(b)(2) requires that responsible potential bidders be given

²⁸³ *Id.* cmt. c(3), at 366-67.

²⁸⁴ *Id.* at 367.

²⁸⁵ *Id.* at 368.

²⁸⁶ *Id.*

²⁸⁷ *Id.* cmt. a(2), at 361.

²⁸⁸ *Id.* cmt. c(1), at 362.

²⁸⁹ *Id.*

access to relevant information and be given reasonable opportunity to bid. This is not the case, however, in a freezeout transaction in which the target is taken over by a controlling shareholder.²⁹⁰ Consequently, Section 7.25, which deals with majority-control freezeouts, "places primary reliance on a combination of an independent bargaining structure and the presence of an adequate appraisal remedy."²⁹¹

The *Project* goes on to say that "[b]ecause a transaction that satisfies the requirements of Section 5.15(b) will have been tested by the market, judicial review is limited to a waste standard."²⁹² This is because Section 5.15(b) is "intended to facilitate alternative proposals for an acquisition of the corporation as a means to police the fairness of a proposed management buyout."²⁹³ The disclosure and market review provisions of Section 5.15(b) are explored in greater detail in Section IV.B below, and the rules regarding appraisal are examined in Section IV.C.

B. The Disclosure and Market Review Requirements of Section 5.15(b)

The *Project* says that Section 5.15(b) "reflects two basic premises."²⁹⁴ First, a market test of the fairness of a management buyout is preferable to judicial review.²⁹⁵ Second, in order to provide a meaningful market test, there must be a reduction in the disadvantages under which potential competitive bidders operate.²⁹⁶ Section 5.15(b) applies only to publicly held corporations because, generally, the opportunity for a market review of the fairness of a transaction is less likely for closely-held corporations.²⁹⁷

²⁹⁰ *Id.* See *infra* Part VII.C.

²⁹¹ 1 ALI CORPORATE GOVERNANCE PROJECT, *supra* note 1, § 5.15 cmt. c(1).

²⁹² *Id.*

²⁹³ *Id.* cmt. c(3), at 366.

²⁹⁴ *Id.*

²⁹⁵ *Id.*

²⁹⁶ *Id.*

²⁹⁷ *Id.* at 370.

If the market test provisions of Section 5.15(b) apply, court review is limited to determining whether the transaction results in a waste of corporate assets.

The *Project* explains that Section 5.15(b) sets out “three transactional requirements”²⁹⁸ that must be satisfied. First, as provided in Section 5.15(b)(1), the proposed transaction must be publicly disclosed. Second, as provided in Section 5.15(b)(2), responsible, potential bidders must be provided with the relevant information concerning the target. Third, as provided in Section 5.15(b)(2), potential bidders must be given a reasonable opportunity to evaluate the information and to prepare a competing bid. In addition to these transactional requirements, the transaction must be approved by both the disinterested directors²⁹⁹ and the disinterested shareholders.³⁰⁰

The purpose of these three transactional requirements is to reduce the informational and timing disadvantages third party bidders “otherwise suffer in attempting to compete with a proposed transaction in control sponsored by corporate insiders.”³⁰¹

Since the purpose of the disclosure requirement is “to alert the market to the opportunity to make a competitive proposal and to the terms against which bidding will take place . . . , the quality and timing of disclosure required under § 5.15(b) is to be judged from the perspective of the needs of a potential competitive bidder sophisticated enough to contemplate a corporate acquisition.”³⁰² Management is not, however, required to disclose their highest possible price.³⁰³

Potential bidders are to be provided the same type of information as is normally provided to investment bankers representing a party to the transaction.³⁰⁴ The target can insist on

²⁹⁸ *Id.* at 366.

²⁹⁹ *See id.* § 5.15(b)(3).

³⁰⁰ *See id.* § 5.15(b)(4).

³⁰¹ *Id.* cmt. c(3), at 366.

³⁰² *Id.* at 366.

³⁰³ *Id.* § 5.15 cmt. c(3), at 368.

³⁰⁴ *Id.* at 366-67.

the receipt of a confidentiality agreement as a condition to release of the information.³⁰⁵

Satisfaction of the requirement that potential bidders be given a reasonable time to respond is dependent upon the size and complexity of both the target and the transaction proposed by management.³⁰⁶

Under Section 5.15(b)(3), it is contemplated that disinterested directors will supervise the negotiation of any agreement and the conduct of any auction in which the interested directors/executives are involved.³⁰⁷ Also, disinterested directors should choose their own legal advisers and investment bankers, without the participation of the interested directors/executives.³⁰⁸

Disinterested directors should determine all aspects of the bidding or auction process, such as whether sealed bids are required.³⁰⁹ Such process is not, however, to favor the interested directors/executives.³¹⁰

Since under Section 6.01(a) the directors can approve, reject or decline to consider an acquisition proposal, the directors will not be liable for loss of a bid submitted on unacceptable conditions, such as a short response period or a demand for preferential treatment.³¹¹

Furthermore, in selecting between competing bids, the directors may accept a bid that "accommodates the factors set forth in § 6.02(a) [relating to actions by a target's directors that has the foreseeable effect of blocking a tender offer], so long as the bid that is accepted is not materially less favorable to the interest of [the] shareholders."³¹² This materially less favorable concept is similar to a concept that applies to defensive tactics in tender offers under Section 6.02.³¹³

Disinterested directors can first enter into an acquisition agreement with interested directors/executives and then satisfy

³⁰⁵ *Id.* at 367.

³⁰⁶ *Id.*

³⁰⁷ *Id.* at 368.

³⁰⁸ *Id.*

³⁰⁹ *Id.*

³¹⁰ *Id.*

³¹¹ *Id.*

³¹² *Id.* at 369.

³¹³ See *infra* Part V.

the conditions of Section 5.15(b) provided the disinterested directors remain free to terminate the agreement with the interested directors/executives and enter into an agreement with a competing bidder.³¹⁴ Normally, prior to the end of the market test period, disinterested directors cannot grant a lock-up to the interested directors/executives.³¹⁵ However, if the disinterested directors have satisfied the conditions of Section 5.15(b) by conducting a fair auction and during the auction the disinterested directors have announced their intention to grant an auction-ending lock-up to the successful bidder, then a reasonable lock-up could be granted to the interested directors/executives if their bid was accepted.³¹⁶

The *Project* gives as an example of an acceptable lock-up an "option to acquire important assets of the corporation if the corporation were acquired by a third party within twelve months."³¹⁷ The *Project* goes on to explain:

[A] lock-up option might appropriately operate to protect the successful bidder from a subsequent competing bid for a reasonable period of time, but it should not constrain the opportunity of target shareholders to reject the successful bidder's proposal, so long as the target's shareholders do not then accept a competing bid within such reasonable period of time.³¹⁸

Also, the limitation on lock-ups does not extend to a commitment made to all bidders to reimburse the reasonable expenses of the successful bidder or to pay a reasonable incentive or topping fee.³¹⁹

The *Project* says that although the adoption of the market test rule in Section 5.15(b) may have the effect of restricting the number of management buyouts, this detriment is out-

³¹⁴ 1 ALI CORPORATE GOVERNANCE PROJECT, *supra* note 1, § 5.15 cmt. c(3), at 369.

³¹⁵ *Id.* (citing *Hanson Trust PLC v. ML SCM Acquisition, Inc.*, 781 F. 2d 264, 283 (2d Cir. 1986); *Mills Acquisition Co. v. MacMillan, Inc.*, 559 A.2d 1261 (Del. 1989)).

³¹⁶ *Id.*

³¹⁷ *Id.*

³¹⁸ *Id.*

³¹⁹ *Id.* at 370.

weighed by higher prices paid to the target's shareholders.³²⁰ The *Project* explains: "Consistent with corporate law's traditional treatment of interested transactions, § 5.15 reflects a conclusion that shareholders are generally better off when the terms of interested transactions are reviewed, even at the risk that the number of such transactions will be reduced."³²¹

The Reporter's Notes indicate that courts have given "special oversight" to transactions in which control is shifted to directors/executives by way of a corporate repurchase of its shares or a recapitalization.³²² Without saying whether such transactions are within the scope of Section 5.15(a), the Reporter's Notes say that the market test rules of Section 5.15(b)(1)-(3) are "intended to provide that oversight through market forces with a minimum of judicial intervention."³²³

C. Appraisal Rights in Management Buyouts

1. Management Buyouts as Transactions in Control Giving Rise to Appraisal Rights

As indicated in Section III.F.2, Section 7.21(a) provides that a shareholder should be entitled to appraisal rights in various types of mergers and acquisitions, unless the shareholders of the target or acquiring corporation own proportionately at least 60% of the stock of the acquiring corporation after the transaction.³²⁴

Also, under Section 7.21(c)(2), appraisal rights arise in a sale of substantial assets that leaves the target without a significant continuing business, unless the sale is in the ordinary course or is for cash or cash equivalents and the target is liquidated.³²⁵ Thus, for example, if a management buyout is effectuated as a merger in which the 60% continuity test is not satisfied (which

³²⁰ *Id.*

³²¹ *Id.*

³²² *Id.* reporter's note 1, at 373, (citing *Black & Decker Corp. v. American Standard, Inc.*, 682 F. Supp. 772 (D. Del. 1988) and *Mills Acquisition Co. v. MacMillan, Inc.*, 559 A.2d 1261 (Del. 1989)).

³²³ *Id.*

³²⁴ 2 ALI CORPORATE GOVERNANCE PROJECT, *supra* note 1, § 7.21(a).

³²⁵ *Id.* § 7.21(c).

would normally be the case) or as a sale of all of a target's assets for something other than cash, the target's shareholders will have appraisal rights.

Also, under Section 7.21(c)(1), a target's shareholders would have appraisal rights in a transaction that falls within the management buyout rules of Section 5.15(a) and which involves a sale of assets accounting for a majority of the corporation's earnings or total assets, unless the market test rules of Section 5.15(b) are satisfied and the target is publicly traded.

The *Project* explains the rules of Section 7.21(c)(1) as follows:

Under the final clause of § 7.21(c)(1), appraisal rights do not arise, even in the case of a management buyout effected through a sale of assets, if the auction procedures specified in § 5.15(b) are followed. In these circumstances, the judgment expressed in § 7.21(c)(1) is that compliance with § 5.15(b) substantially mitigates the conflict of interest problem. Given that § 5.15(b) supplies an adequate market test, there is no need to extend a judicial remedy through appraisal when this test is satisfied.³²⁶

The *Project* gives as an illustration of the above rules a situation in which senior management of a public target corporation become significant shareholders of an acquiror that acquires 70% of the target's assets in an LBO. The example holds that since the transaction is governed by Section 5.15, a right of appraisal arises under Section 7.21(c)(1) "regardless of whether the remaining assets of the corporation constitute a 'significant continuing business,'" unless the market test rules of Section 5.15(b)(1)-(3) are satisfied.³²⁷

The market test exception to the appraisal right in management buyouts apparently does not apply to such transactions that are effectuated as mergers under Section 7.21(a) or as sales of all (or substantially all) of the target's assets in a transaction in which the target fails to continue a significant line of business as specified in Section 7.21(c)(2). The exception on its face only applies under Section 7.21(c)(1) to a sale of a majority of the target's assets in a situation in which the target

³²⁶ *Id.* § 7.21 cmt. c(3), at 306.

³²⁷ *Id.* illus. 3, at 308.

continues a significant business. Thus, the market exception would apply in narrow circumstances.

2. Determining Fair Value in Interested Party Transactions Like MBOs

Section 7.22(c) provides that in an interested party acquisition, which includes management buyouts under Section 5.15, non-majority control freezeouts under Section 5.10,³²⁸ and majority control freezeouts under Section 7.25,³²⁹ the "court generally should give substantial weight to the highest realistic price that a willing, able, and fully informed buyer would pay for the corporation as an entirety."³³⁰ In making such determination the court can, unless it would be unreasonable to do so, "include a proportionate share of any gain reasonably to be expected to result from the combination."³³¹

The *Project* explains that Section 7.22(c) does not require that fair market value be determined by the "presumed outcome of a hypothetical competitive auction."³³² Further, the *Project* says that in self interested transactions under Sections 5.10, 5.15 and 7.25 the "court generally should not average alternative valuation measures, but instead should value the property at its most efficient use"³³³

The *Project* indicates that in a parent-subsidiary transaction under Section 7.25 in which the parent has held the subsidiary's stock for a substantial period, there may be a sound justification for departing from an auction standard, because a third party bidder could not prevail with an offer over the parent's objection.³³⁴ The same is not true in management buyouts under Section 5.15 and non-majority control transactions under Section 5.10.

The *Project* points out that in interested party transactions governed by Section 7.22(c), it must be "recognized that many

³²⁸ See *infra* Part VII.B.

³²⁹ See *infra* Part VII.C.

³³⁰ 2 ALI CORPORATE GOVERNANCE PROJECT, *supra* note 1, § 7.22(c).

³³¹ *Id.*

³³² *Id.* § 7.22 cmt. d, at 320.

³³³ *Id.* cmt. c, at 316.

³³⁴ *Id.* cmt. d, at 321.

firms trade at a market value that is well below their liquidation or 'asset sale' value"³³⁵ and that it would be "fundamentally inconsistent with management's fiduciary responsibilities if it could acquire a corporation's business for itself based on either the firm's current market or going concern value when a third party had offered, or would offer, a higher price."³³⁶ Failure to require the type of third party valuation called for in Section 7.22(c) in such situations would "create an incentive for conduct that is functionally equivalent to insider trading."³³⁷

The *Project* does not specify how the third party sales price is to be determined. It would appear, however, that the price paid in the transaction would be deemed to satisfy this standard if the price was determined by a process in which

disinterested directors have in fact negotiated on behalf of the controlled corporation [or the target in a management buyout] in an arm's length fashion and appropriate factual investigation (which may include securing the opinions of qualified experts) has established substantial objective evidence for the determination that the consideration offered to the minority shareholders constitutes fair value for their shares³³⁸

Although this statement is made in the context of determining whether appraisal is the exclusive remedy in a majority control freezeout governed by Section 7.25,³³⁹ the same principle should apply in determining fair value in an appraisal proceeding.

Thus, it would appear that if in an appraisal proceeding involving a management buyout under Section 5.15, a non-majority control freezeout under Section 5.10 or a majority control freezeout under Section 7.25, the merger consideration is determined through arm's length type bargaining with disinterested directors, then the merger consideration should gener-

³³⁵ *Id.* at 323 (citing *Radol v. Thomas*, 772 F.2d 244 (6th Cir. 1985) (noting that a company's appraisers estimated asset values as high as \$323, while stock was trading at \$64).

³³⁶ *Id.*

³³⁷ *Id.* at 324.

³³⁸ *Id.* § 7.25 cmt. c(1), at 385.

³³⁹ See *supra* Part VII.C.2.c.

ally be found to constitute fair value. As a practical matter, the use of an independent negotiating structure in these situations should discourage the use of appraisal proceedings.

On the other hand, the *Project* contains an example involving a freezeout transaction in which a parent corporation that owns 50% of the subsidiary's stock acquires the subsidiary's other shares in a freezeout transaction for \$30 per share, \$6 above the trading value of those shares. The value of the sub's shares using the discounted cash flow technique is \$32 per share. After the merger, a third corporation offered \$40 per share for the sub. The example concludes that "the court should award dissenting shareholders \$40 per share, which represents their proportionate interest in the [s]ubsidiary valued at the highest price that a willing and informed buyer would pay."³⁴⁰

The *Project* points out that recent decisions in Delaware and Maine have rejected the use of minority discounts,³⁴¹ and that Section 7.22(a) follows this rule by requiring the valuation of "the firm as whole, not specific shares, and [the] allocat[ion] [of] that value proportionately, absent extraordinary circumstances."³⁴²

The *Project* indicates that under Section 7.22(c), synergistic gains are to be divided proportionately between the acquiror and the target in determining the value of the target's shares.³⁴³ A proportionate allocation of synergistic gains should not, however, be used if such an allocation would result in an undeserved windfall.³⁴⁴

3. Non-Exclusivity of Appraisal Proceedings for Management Buyouts

Section 5.15(c) provides that even if the target's shareholders in a management buyout are entitled to an appraisal remedy,

³⁴⁰ 2 ALI CORPORATE GOVERNANCE PROJECT, *supra* note 1, § 7.22 cmt. e, illus. 4, at 328.

³⁴¹ *Id.* at 324 (citing *Cavalier Oil Corp. v. Harnett*, 564 A.2d 1137 (Del. 1989); *In re Valuation of Common Stock of McLoon Oil Co.*, 565 A.2d 997 (Me. 1989)).

³⁴² *Id.*

³⁴³ *Id.* at 327.

³⁴⁴ *Id.*

which will normally be the case,³⁴⁵ the appraisal proceeding is not the exclusive remedy of a shareholder who proposes to challenge the transaction. If, however, the transaction also falls within Section 7.25, which involves freezeout transactions in which a majority shareholder is a party, then appraisal is the exclusive remedy.

The *Project* makes it clear that non-exclusivity applies even if the burden shifting procedures in Section 5.15(b) are followed.³⁴⁶ The *Project* explains:

The shareholders' remedy will normally be to enjoin or rescind the transaction or to hold the interested directors, principal senior executives, or their associates liable for breach of their duty of fair dealing. Disinterested directors who approve the transaction will be entitled to the protection of the business judgment rule so long as they satisfy the requirements of § 4.01(c).³⁴⁷

Even though appraisal is not the exclusive remedy for a transaction that has been market tested under the provisions of Section 5.15(b), court review is limited to determining whether the transaction results in a waste of corporate assets.³⁴⁸ Consequently, this remedy is likely to be of little practical utility to challenging parties.

D. Application of the ALI MBO Rules of Section 5.15 and Related Appraisal Rules to the Time-Warner Transaction

1. The Section 5.15 MBO Rules

As indicated in Section III.G, the originally proposed Time-Warner merger would have been a transaction in control under Section 1.38(a) of the *Project* with respect to both Time and Warner. As a consequence, under Section 5.15(a), if the directors or principal senior executives of either corporation were

³⁴⁵ See *supra* Part IV.C.1.

³⁴⁶ 1 ALI CORPORATE GOVERNANCE PROJECT, *supra* note 1, § 5.15 cmt. c, at 364.

³⁴⁷ *Id.*

³⁴⁸ *Id.* at 371.

"interested" in the transaction (as defined in Section 1.23), then such directors or principal senior executives would have the burden of proving that the transaction was fair to the shareholders unless the market test conditions of Section 5.15(b) were satisfied.

In the Time-Warner transaction certain directors of both companies (particularly the Chief Executive Officer of Warner, Steven Ross) were to receive substantial benefits resulting from the merger and it is conceivable that such benefits (such as an investment interest that is disproportionate to the executive's pre-acquisition stock interest³⁴⁹ or long term employment contracts that would not otherwise be available)³⁵⁰ would have caused such directors to be interested in the transaction, thereby implicating Section 5.15(a). The *Project* contains the following example that clearly indicates that Section 5.15 can apply to what appears to be an arm's length merger:

XYZ Corp. merges into ABC Corp. at an exchange rate of \$60 in cash per XYZ share. The senior executives of XYZ Corp. receive long-term employment contracts from ABC Corp., which contracts significantly increase their compensation over current levels. Plaintiffs discover that the senior executives of XYZ Corp. rebuffed two other offers on otherwise equivalent terms of \$66 and \$67 in cash from other corporate suitors at about the time they accepted ABC's merger proposal. These offers did not include increased compensation or employment contracts for these executives. Such information, if adequately documented, could constitute clear and convincing evidence sufficient to overcome the presumption created by § 7.22(b). If the court were so to conclude and if it finds that the transaction falls under § 5.15 (because a principal senior executive was interested), it should look to § 7.22(c) as its basic valuation standard. If § 5.15 is not applicable, the court should use the valuation standard specified in § 7.22(a), but it may give substantial weight thereunder to the higher prices offered by the other bidders.³⁵¹

³⁴⁹ *Id.* at 364.

³⁵⁰ 2 ALI CORPORATE GOVERNANCE PROJECT, *supra* note 1, § 7.22 cmt. c, illus. 2, at 317-18.

³⁵¹ *Id.*

If the originally proposed Time-Warner merger had been subject to Section 5.15, the acquisition would probably have been restructured to satisfy the market test rules of Section 5.15(b) so as to eliminate the burden on the interested directors of proving that the transaction was fair. Alternatively, the transaction could have been restructured to ensure that none of the directors or principal senior executives had an interest in the transaction.

As indicated above, the market test rule of Section 5.15(b) is satisfied if each of the following conditions is satisfied:

- (1) Public disclosure of the proposed transaction is made;
- (2) Responsible persons who express an interest are provided relevant information concerning the corporation and given a reasonable opportunity to submit a competing proposal;
- (3) The transaction is authorized in advance by disinterested directors . . . after the procedures set forth in Subsections (1) and (2) have been complied with; and
- (4) The transaction is authorized or ratified by disinterested shareholders. . . .³⁵²

If these conditions are met then the "party challenging the transaction has the burden of proving that the terms of the transaction are the equivalent of a waste of corporate assets."³⁵³

If Section 5.15 would have been applicable to Time in the originally proposed Time-Warner merger, and Time had been put up for auction under the market test rule of Section 5.15(b), then Paramount probably would have been successful in acquiring Time.

Although Section 5.15 is directed at traditional management buyouts, this section is written very broadly, and, as a consequence, in any transaction in control and in any tender offer that results in a transfer of control of the corporation to another person, it is necessary to determine whether directors or principal senior executives are interested as defined in Section 1.23. If they are interested, then Section 5.15 is implicated even

³⁵² 1 ALI CORPORATE GOVERNANCE PROJECT, *supra* note 1, § 5.15(b).

³⁵³ *Id.*

if the transaction is an all equity merger as in the case of the originally proposed Time-Warner merger. This is the case even though the drafters of the *Project* apparently did not contemplate that the Time-Warner transaction would be subject to Section 5.15.

2. Right of Appraisal if Originally Proposed Merger were Tested as a MBO Under Section 5.15

As indicated above, the originally proposed Time-Warner merger could have constituted a MBO under Section 5.15 of the *Project* with respect to either or both Time and Warner if a director or principal senior executive of the particular corporation was "interested" in the transaction. The merger between Time and Warner is a Section 7.21(a) transaction, and as a consequence, appraisal rights would have applied to Time shareholders but not to Warner shareholders (because of the 60% continuity test), as explained in Section III.G.5.³⁵⁴

3. Exclusivity of Appraisal Proceedings if Originally Proposed Merger were Treated as a MBO Under Section 5.15

If the originally proposed merger were treated as a MBO under Section 5.15 of the *Project*, appraisal would not be the exclusive remedy under Section 7.24. However, if the market test provisions of Section 5.15(b) were satisfied, then the party challenging the transaction would have the burden of proving that the terms of the transaction are equivalent to a "waste of corporate assets."³⁵⁵

³⁵⁴ Also, if the transaction were treated as a MBO with respect to Warner, then presumably appraisal rights for Warner would have arisen under Section 7.21(c)(1), which deals with a sale of a majority of the assets, even though the transaction was not structured as a sale of assets, because the economic substance of a merger is the same as the sale of all of Warner's assets.

However, if the transaction were treated as a MBO for Warner and the rules of Section 7.21(c)(1) applied, the appraisal remedy would not apply if the market test rules of Section 5.15(b)(1) - (3) have been complied with. See 2 ALI CORPORATE GOVERNANCE PROJECT, *supra* note 1, § 7.21(c)(1).

³⁵⁵ 1 ALI CORPORATE GOVERNANCE PROJECT, *supra* note 1, § 5.15(b).

Section 5.15(c) makes it clear that appraisal is not the exclusive remedy in a management buyout unless the transaction also falls under the majority controlled freezeout rule in Section 7.25 of the *Project*. Thus, although appraisal is not the exclusive remedy for a MBO if the market test rules are satisfied, as a practical matter the challenging party has no rights to challenge the transaction because it is inconceivable that the market test rules could have been satisfied and the transaction could also constitute a "waste of corporate assets."

4. Determining Fair Value of Shares in Appraisal Proceeding if Originally Proposed Merger were Treated as a MBO Under Section 5.15

If the originally proposed merger had been treated as a MBO and the market test rules of Section 5.15(b) were satisfied, then a challenging party could challenge the transaction on the basis of waste of assets. As indicated above, if the market test is satisfied it is highly unlikely that the challenging party could establish a waste of assets. Thus, the challenging party's only effective remedy is appraisal, notwithstanding the fact that appraisal is not the exclusive remedy. Section 7.22(c) provides that in a management buyout under Section 5.15 the appraisal court should "give substantial weight to the highest realistic price that a willing, able and fully informed buyer would pay for the corporation as an entirety."³⁵⁶ Thus, the *Project* points out that in this type of transaction the shareholders are entitled to auction or liquidation value. However, since under Section 5.15(b)(3), disinterested directors must approve the market tested transaction, it would appear that an appraisal proceeding would find that the consideration paid in the transaction constitutes fair value for the shares. Consequently, if a transaction falls within Section 5.15(b), appraisal proceedings should be rare.

³⁵⁶ 2 ALI CORPORATE GOVERNANCE PROJECT, *supra* note 1, § 7.22(c). See also *id.* § 7.22 cmt. c, illus. 2, at 317-18 and *supra* Part III.G.7.

E. Observation

Section 5.15 has a broad sweep; it is not limited to the traditional type of management buyout. It could apply even in an all equity merger like the originally proposed Time-Warner merger if the target's executives or directors are interested in the transaction. It could be expected that if the principles of Section 5.15 are adopted many transactions that are currently thought to be arm's length mergers and acquisitions would be put to the market review test of Section 5.15(b).

V. ACTION BY TARGET'S DIRECTORS THAT HAS THE FORSEEABLE EFFECT OF BLOCKING AN UNSOLICITED TENDER OFFER

A. In General

Section 6.02(a), which applies only to publicly held corporations, governs the actions of a target's directors in defending against a tender offer by an unwanted acquiror for the stock of the target. Under Section 6.02(a), a target's board "may take an action that has the foreseeable effect of blocking an unsolicited tender offer, if the action is a reasonable response to the offer."³⁵⁷ Section 5.15, which governs management buyouts,³⁵⁸ and not Section 6.02, applies if the directors of the target have an interest in the acquiring entity.³⁵⁹

Section 6.02(b) provides that in determining whether its action is a reasonable response to the offer, the board may take into account "all factors relevant to the best interests of the corporation and [its] shareholders"³⁶⁰ Such factors include the issue of whether the offer is legal and whether the offer would, if successful "threaten the corporation's essential economic prospects."³⁶¹ In addition, the board may give consideration to the interests of non-shareholder groups for which the corporation has a "legitimate concern if to do so would not

³⁵⁷ 1 ALI CORPORATE GOVERNANCE PROJECT, *supra* note 1, § 6.02(a).

³⁵⁸ See *supra* Part IV.

³⁵⁹ 1 ALI CORPORATE GOVERNANCE PROJECT, *supra* note 1, § 6.02 cmt. a, at 408.

³⁶⁰ *Id.* § 6.02(b)(1).

³⁶¹ *Id.*

significantly disfavor the long-term interests of shareholders.³⁶² Thus, to a limited extent the interests of other constituencies may be considered. The *Project* says that most of the statutes authorizing a target's directors to take into consideration the impact on constituencies other than shareholders³⁶³ can be interpreted in a manner consistent with Section 6.02.³⁶⁴

The *Project* says that the use of the term "best interest" is to "negat[e] any notion that the only important criterion is whether an immediate premium over market price is offered."³⁶⁵ Although the appropriate economic criterion is one that examines the long-term benefits, "[i]n some cases, long-term benefits are likely to be greater by taking an immediate profit."³⁶⁶ Other factors that may be taken into account include the nature, timing and adequacy of the offer and the risk that the offer will not be consummated.³⁶⁷ A significant premium is only one of the factors to be considered.³⁶⁸

The *Project* explains that the non-shareholder interests and groups that may be considered include "environmental and other community concerns, and may include groups, such as employees, suppliers, and customers."³⁶⁹

The Reporter's Notes say that the formulation in Section 6.02(b)(2) goes beyond the traditional law in Delaware concerning the authority to consider other constituencies.³⁷⁰ This Delaware standard, which is the prevailing standard, allows directors to give consideration to the interests of others but "compel them to find some reasonable relationship to the long-term interests of shareholders when doing so."³⁷¹

³⁶² *Id.* § 6.02(b)(2).

³⁶³ *See, e.g.*, PA. CONS. STAT. § 1715 (1995).

³⁶⁴ 1 ALI CORPORATE GOVERNANCE PROJECT, *supra* note 1, § 6.02 cmt. a, at 410.

³⁶⁵ *Id.* cmt. c(2), at 413.

³⁶⁶ *Id.*

³⁶⁷ *Id.*

³⁶⁸ *Id.* at 413-14.

³⁶⁹ *Id.* at 414.

³⁷⁰ *Id.* reporter's note 2, at 427-28.

³⁷¹ *Id.* (quoting American Bar Association, Committee on Corporate Laws, *Other Constituencies Statutes: Potential for Confusion*, 45 BUS. LAW. 2253,

Under Section 6.02(c), the person who asserts that an action of directors fails to satisfy the standards of Section 6.02(a) has the "burden of proof that the board's action is an unreasonable response to the offer."³⁷² Thus, as discussed more fully in Section V.B below, the *Project* rejects the *Unocal* principle which puts the burden of proof on the directors taking the defensive action.

Under Section 6.02(d), an action that does not satisfy the standards of Section 6.02(a) may be enjoined or set aside, but the directors who authorize such action may not be held personally liable for damages if their conduct satisfies the standards of the business judgment rule under Section 4.01(c).³⁷³ To come within the business judgment rule, the director must act in good faith, must not be interested in the transaction, must be informed concerning the action to the extent the director reasonably believes is appropriate under the circumstances, and must rationally believe that the action is in the best interest of the corporation.

Directors should not be considered as interested "solely because of the prospective loss of usual and customary directors' fees and perquisites"³⁷⁴ Also, a director's position as a shareholder should not cause him or her to be considered interested as long as no special treatment is received.³⁷⁵ On the other hand, the potential loss of a position as a senior executive would be considered a disabling interest.³⁷⁶

Section 6.02(d) contemplates that a blocking action taken by a target's disinterested directors may not be a reasonable response to an offer as required by Section 6.02, but may still satisfy the business judgment rule of Section 4.01(c).

2260-61, 2269 (1990)).

³⁷² *Id.* § 6.02(c).

³⁷³ *See supra* Part II.C.

³⁷⁴ 1 ALI CORPORATE GOVERNANCE PROJECT, *supra* note 1, § 6.09 cmt. a, at 409.

³⁷⁵ *Id.*

³⁷⁶ *Id.*

B. Rejection of *Unocal*'s Allocation of the Burden of Proof

Section 6.02 should be compared with the principle in *Unocal v. Mesa Petroleum Co.*³⁷⁷ There the court held that if a target's directors take action to block an unsolicited tender offer, the directors have the burden of proving that they had reasonable grounds for believing that the offer posed a danger to corporate policy and effectiveness and that their blocking action was reasonable in relation to the threat posed.³⁷⁸ The burden of showing reasonable grounds for believing a danger to corporate policy is satisfied by a showing of good faith and reasonable investigation.³⁷⁹ If the directors satisfy this two pronged burden, then they are given protection under the business judgment rule.³⁸⁰

The *Project* points out that this *Unocal* principle has been referred to by courts as an "intermediate" or "enhanced business judgment standard of review."³⁸¹ This standard lies between the normal business judgment rule and the entire fairness test that can apply in certain interested party transactions.

The *Project* says that Section 6.02 is "intended to be consistent with the so-called *Unocal* test."³⁸² The *Project* goes on to note, however, that whereas the directors have the burden under *Unocal*, under Section 6.02, the challenging party has the burden of proving that the director's blocking action was unreasonable.³⁸³ This is a major difference.

The *Project* says that Section 6.02 rejects the view found in certain cases, such as *Norlin Corp. v. Rooney Pace, Inc.*³⁸⁴ and

³⁷⁷ 493 A.2d 946, 955 (Del. 1985).

³⁷⁸ 1 ALI CORPORATE GOVERNANCE PROJECT, *supra* note 1, § 6.02 cmt. a, at 406 (citing in addition to *Unocal*, *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986) and *AC Acquisition Corp. v. Anderson, Clayton & Co.*, 519 A.2d 103 (Del. Ch. 1986)).

³⁷⁹ *Id.* at 407.

³⁸⁰ *Id.*

³⁸¹ *Id.* at 406.

³⁸² *Id.*

³⁸³ *Id.* at 407.

³⁸⁴ 744 F.2d 255 (2d Cir. 1984).

Cheff v. Mathes,³⁸⁵ that judicial review of the blocking actions of a target's board should be based on a duty of loyalty analysis.³⁸⁶ The *Project* points out that under this approach if "directors' blocking actions suggest that the directors' motive was retention of control, the business judgment rule is inapplicable and the action of the directors . . . is subject to review under a duty of loyalty standard, with the burden on the directors to prove the fairness of their actions."³⁸⁷ Review under the duty of loyalty, the *Project* argues, "cannot effectively distinguish between cases in which directors favored themselves and cases in which directors properly looked to the interest of the shareholders."³⁸⁸

The *Project* points out that Section 6.02(a) does not call for analyzing the subjective intent or motives of directors but rather imposes an objective standard for determining first whether an action had the foreseeable effect of blocking a tender offer and if so, then whether such action was reasonable.³⁸⁹

C. Effect on Control Share, Business Combination and Similar Statutes

The *Project* points out that states have adopted a variety of provisions dealing with hostile offers,³⁹⁰ including (1) statutes that require or permit directors to consider long-term as well as short-term interests of the corporation and the shareholders;³⁹¹ (2) control share acquisition statutes that can deny a controlling shareholder the right to vote;³⁹² (3) fair price statutes that require that the price paid in a second-step transaction be the same as the price paid in the first-step;³⁹³ (4)

³⁸⁵ 199 A.2d 548, 555 (Del. 1964).

³⁸⁶ 1 ALI CORPORATE GOVERNANCE PROJECT, *supra* note 1, § 6.02 cmt. a, at 407-08.

³⁸⁷ *Id.* at 407.

³⁸⁸ *Id.* at 408.

³⁸⁹ *Id.*

³⁹⁰ *Id.* at 410-11.

³⁹¹ See IND. CODE § 23-1-35-1(g) (1995).

³⁹² See *id.* § 23-1-42-1 to -11.

³⁹³ See MD. CODE ANN., CORPS & ASS'NS § 3-601 to -603 (1993 & Supp. 1995).

business combination statutes that prevent for a specified period the consummation of a second-step merger in certain circumstances;³⁹⁴ and (5) disgorgement statutes that require controlling shareholders to disgorge profits made after an unsuccessful takeover attempt.³⁹⁵

The *Project* says that some of these statutes give the directors the discretion to render the statute inapplicable, or to otherwise affect the operation of the statute. Section 6.02, however, takes no position regarding the standard of review applicable to the exercise of such discretion.³⁹⁶ The Reporter's Notes say that operation under these statutes is to be governed by "statutory interpretation[s] as applied to the particular statute."³⁹⁷

D. Comparison of the Section 6.02 Standard with the Business Judgment Rule

In setting out the rationales behind Section 6.02, the *Project* says that since shareholders normally have the right to sell their shares without restriction, a blocking action by the board goes far beyond the normal board function of conducting the corporation's business and requires a special justification.³⁹⁸ It is not sufficient to judge such actions by the business judgment rule or the duty of loyalty or fair dealing. Rather, such actions should be

judged according to whether the action is a reasonable response to the offer, taking into account the factors set out in § 602(b)(1) [all factors relevant to the best interests of the corporation and shareholders], as well as factors designated in § 6.02(b)(2) [other interests or groups with respect to which the corporation has a legitimate concern].³⁹⁹

³⁹⁴ See DEL. CODE ANN. tit. 8, § 203 (1993).

³⁹⁵ See 15 PA. CONS. STAT. ANN. §§ 2571-73 (1995).

³⁹⁶ 1 ALI CORPORATE GOVERNANCE PROJECT, *supra* note 1, § 6.02 cmt. a, at 411.

³⁹⁷ *Id.* reporter's note 5, at 431.

³⁹⁸ *Id.* cmt. c, at 411.

³⁹⁹ *Id.*

Thus, the fundamental difference between the enhanced business judgment rule in Section 6.02 and the standard business judgment rule of Section 4.01(c) can be articulated as follows. Under the standard rule, disinterested directors acting in good faith and on an informed basis must "rationally believe that the business judgment is in the best interests of the corporation."⁴⁰⁰ On the other hand, under Section 6.02, the action taken must be reasonable in response to the offer and in the best interests not just of the corporation but also of shareholders. Also, the directors may take into consideration the impact on other constituencies, so long as this does not significantly disfavor the long term interests of shareholders.

The *Project* indicates that "[u]nder normal circumstances, the best interests of the corporation and its shareholders will coincide."⁴⁰¹ As indicated, in liability actions against disinterested directors the normal business judgment rule applies.⁴⁰²

E. General Scope of Defensive Actions

The *Project* indicates that Section 6.02 does not deter the directors' ability to vigorously urge the shareholders to reject an unsolicited offer and to expend corporate funds for this purpose.⁴⁰³ Also, directors may, on advice of counsel that there are substantial grounds, initiate litigation.⁴⁰⁴

Section 6.02 does not impose on a target's directors the duty to conduct an auction,⁴⁰⁵ and this provision permits a target's directors to take both pre-planning actions in response to possible future tender offers, as was the case in *Moran v. Household International, Inc.*,⁴⁰⁶ with the issuance of a poison pill, and current actions in response to an existing tender offer.⁴⁰⁷

⁴⁰⁰ *Id.* at § 4.01(c)(3).

⁴⁰¹ *Id.* at cmt. c, 413.

⁴⁰² *Id.* at 411 and § 6.02(d).

⁴⁰³ *Id.* cmt. c, at 414.

⁴⁰⁴ *Id.* at 415.

⁴⁰⁵ *Id.* at 420.

⁴⁰⁶ 500 A.2d 1346, 1350 (Del. 1985).

⁴⁰⁷ 1 ALI CORPORATE GOVERNANCE PROJECT, *supra* note 1, § 6.02 cmt. c(5), at 415.

F. Self-Tenders

The directors may take action that gives the shareholders an alternative to an unsolicited tender offer, provided such alternative does not preclude consideration by the shareholders of the unsolicited offer.⁴⁰⁸ Thus, coercive alternatives “usually [would] not satisfy Section 6.02.”⁴⁰⁹ In this regard the *Project* says that a “premium self-tender for less than the number of shares sought by the pending offer may have the same coercive effect as a front-end loaded two-tier offer by a third-party bidder.”⁴¹⁰ Although such a coercive self-tender may be a reasonable response to an offer, special scrutiny by the court would be appropriate.⁴¹¹

The *Project* illustrates the types of self-tenders that are and are not coercive. If a partial self-tender expires at the same time as a third-party tender offer for all the shares and is at a higher price, the self-tender may have the effect of coercing the shareholders to tender into the self-tender even if they think the third party offer is more favorable.⁴¹² On the other hand, if the self-tender expires after the third-party offer so that the shareholders may still tender into the third party offer, the self-tender is not coercive.⁴¹³ If both the self-tender and the third party offers are made for the same number of shares, then the self-tender is not coercive.⁴¹⁴

G. Reaction to Coercive Two-Tier Offers

Directors’ action designed to protect shareholders from a coercive two-tier tender offer by a third party would fall within Section 6.02 and be subject to its standards. Such two-tier offers may be structured to force shareholders to tender in order to participate in the higher price being offered in the

⁴⁰⁸ *Id.*

⁴⁰⁹ *Id.*

⁴¹⁰ *Id.*

⁴¹¹ *Id.*

⁴¹² *Id.* illus. 1, at 415-16.

⁴¹³ *Id.* illus. 2, at 416.

⁴¹⁴ *Id.* illus. 3, at 416.

first-step. This can be illustrated by the prisoner's dilemma model. For example, assume that a third party's first-step offer is at \$100 per share for 50% of the target's stock and the second-step merger is going to be at \$50 per share for the balance of the shares. Also, assume that if the tender offer is not consummated, the target's shares will have a value of \$125 per share. Assume that there are two shareholders of target, A and B, each owning 50% of the shares. If neither tenders, both will own shares with a value of \$125 per share. If both tender, each will receive cash of \$75, \$100 for half their shares and \$50 for the other half. If A tenders but B does not, A will receive \$100 per share and B will receive only \$50 per share. Under these alternatives it can be expected that both A and B will tender in order to avoid the worst result of receiving \$50 per share, even though they would both be better off by not tendering.⁴¹⁵ The non-tendering option is not chosen because A and B cannot be certain that the other will not tender and if one tenders and the other does not, the non-tendering shareholder ends up in the worst situation.

H. Redemption of Poison Pills

The *Project* says that under Section 6.02 in the face of a hostile offer a target's board will be required to redeem a shareholders' rights plan, "unless the board reasonably concluded that continuance of the rights would be in the best interests of the corporation and its shareholders."⁴¹⁶ And, the board generally could not under Section 6.02 create a rights plan that blocked all future unsolicited tender offers.⁴¹⁷

The Reporter's Notes say that the Reporters believe that the results in *Interco*,⁴¹⁸ *Pillsbury*,⁴¹⁹ *Anderson*, *Clayton*,⁴²⁰

⁴¹⁵ See, e.g., Lucian A. Bebchuk, *Toward Undistorted Choice and Equal Treatment in Corporate Takeovers*, 98 HARV. L. REV. 1693 (1985).

⁴¹⁶ 1 ALI CORPORATE GOVERNANCE PROJECT, *supra* note 1, § 6.02 cmt. c(10), at 423.

⁴¹⁷ *Id.*

⁴¹⁸ *City Capital Assoc. L.P. v. Interco, Inc.* 551 A.2d 787 (Del. 1988), *appeal dismissed*, 556 A.2d 1070 (Del. 1988).

⁴¹⁹ *Grand Metro. Pub. Ltd. v. The Pillsbury Co.*, 558 A.2d 1049 (Del. 1988).

⁴²⁰ *AC Acquisition Corp. v. Anderson, Clayton & Co.*, 519 A.2d 103 (Del.

Polaroid,⁴²¹ and *Time-Warner*⁴²² are consistent with Section 6.02.⁴²³

Interco and *Pillsbury* show that in the absence of unusual facts, at an appropriate time, directors have an obligation to redeem a poison pill and allow the shareholders to consider a tender offer. In *Anderson, Clayton*, the court enjoined a partial self-tender that was in response to an adequately priced, non-coercive third-party tender offer. In *Polaroid* the court refused to enjoin a coercive management self-tender made in response to a third-party tender offer in view of the difficulty in valuing the target. *Polaroid* shows that even an adequately priced non-coercive tender offer with a commitment to do the back-end at the same price as the front-end can constitute a threat to the business plans of the corporation.

I. Effect of the *Time* Decision and the "Just Say No" Defense

The Project follows the principles of *Paramount Communications, Inc. v. Time, Inc.*⁴²⁴ in providing that "Section 6.02 does not require a corporation to abandon its existing business plans simply because someone has made a tender offer for its shares."⁴²⁵ Such business plans include acquisitions and dispositions of substantial businesses and raising capital by the issuance of securities.⁴²⁶ If the implementation of the business plan would prevent the consummation of the offer, the directors should be prepared to present evidence that the timing for implementing the plan was independently determined.⁴²⁷ The *Project* illustrates this point in an example in which a target that has been negotiating to sell a subsidiary receives a tender

1986).

⁴²¹ *Shamrock Holdings, Inc. v. Polaroid Corp.*, 559 A.2d 278 (Del. 1989).

⁴²² *Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140 (Del. 1990).

⁴²³ 1 ALI CORPORATE GOVERNANCE PROJECT, *supra* note 1, § 6.02 reporter's note 4, at 430.

⁴²⁴ 571 A.2d 1140 (Del. 1990).

⁴²⁵ 1 ALI CORPORATE GOVERNANCE PROJECT, *supra* note 1, § 6.02 cmt. c, at 416.

⁴²⁶ *Id.*

⁴²⁷ *Id.* at 417.

offer conditioned on the abandonment of the sale. Assuming the target's directors decide that the sale of the subsidiary is in the best interest of the corporation and shareholders, they may proceed with the sale.⁴²⁸

Another illustration follows the facts in the *Time* case. In this example corporations A (*Time*) and B (*Warner*) negotiate a transaction in which Warner will merge into Time. Prior to completion of the merger, corporation C (*Paramount*) makes a tender offer for Time at an 80% premium, conditioned upon termination of the merger. Time's directors, after analysis, determine that it is in the best interest of Time and its shareholders for Time to combine with Warner. As a result, Time commences a tender offer for 100% of Warner's stock. No other action is taken to block Paramount's tender offer. Paramount sues to enjoin Time's tender offer. The example holds that Time's offer can proceed, unless Paramount can establish that Time's director's action "was not a reasonable response to the offer"⁴²⁹ and that a mere showing of the premium offered to Time's shareholders is "not alone sufficient to satisfy . . . [Paramount's] burden of proof under § 6.02."⁴³⁰

Section 6.02 allows the directors to take action to prevent the consummation of a tender offer that would cause substantial harm to the corporation, such as an offer that would result in the assumption by the target of a large indebtedness that would threaten the corporation's essential economic prospects.⁴³¹ An expected post-tender offer sale by the acquiror of a substantial portion of the target's businesses would not necessarily be a threat to the corporation's essential economic prospects.⁴³² Also, the directors may consider whether the incurrence of indebtedness for the purpose of making payments to shareholders will be considered a fraudulent conveyance that might subject the shareholders to liability in the event of an insolvency proceeding.⁴³³

⁴²⁸ *Id.* illus. 4, at 417.

⁴²⁹ *Id.* illus. 5, at 418.

⁴³⁰ *Id.* at 418.

⁴³¹ *Id.* cmt. c(7), at 419.

⁴³² *Id.*

⁴³³ *Id.* at 418 (citing, *inter alia*, *United States v. Tabor Court Realty Corp.*, 803 F.2d 1288 (3d Cir. 1986), *cert denied sub nom.* *McClellan Realty Co. v.*

The *Project* indicates that the target's directors have wide latitude in responding to a tender offer:

Under some circumstances, such as where a tender offer is for less than all of the shares, or where the corporation is seeking to increase the offer to one that the board of directors has a reasonable basis for concluding is adequate, or to develop other alternative actions, such as a restructuring that the directors view as in the long-term interests of shareholders, . . . the directors should be able under § 6.02 to take action to block a tender offer.⁴³⁴

For example, Section 6.02 does not require the target's directors to auction the target; the directors can make their judgment as to the best offer. Further, the directors may accept a lower offer that affords greater protection to employees or other groups "so long as the offer accepted is not significantly lower than the higher competing offer."⁴³⁵ Also, the directors can act to block a tender offer if they have information concerning the target's value that cannot be disclosed without seriously injuring the corporation.⁴³⁶ In such a case, "a court would be expected to give close scrutiny to the reasonableness of the directors' conclusion that disclosure would result in a competitive disadvantage."⁴³⁷ Also, directors may cause the corporation to enter employment agreements with key employees, even during the pendency of an unsolicited tender offer, and to provide generous severance arrangements in such agreements.⁴³⁸

On the other side of the ledger, the *Project* says: "On the other hand, there will be some sets of facts where the board will not be able to block the tender offer and satisfy the requirements of § 6.02."⁴³⁹ Thus, the reasonable response standard in Section 6.02(a) coupled with the imposition in Section 6.02(c) of the burden of proof on the challenging party will have

United States, 483 U.S. 1005 (1987)).

⁴³⁴ *Id.* cmt. c(8), at 420.

⁴³⁵ *Id.*

⁴³⁶ *Id.* at 421.

⁴³⁷ *Id.*

⁴³⁸ *Id.* cmt. c(10), at 424.

⁴³⁹ *Id.* cmt. c(8), at 420.

the effect of protecting most blocking actions taken by the target's directors.

J. Application of the Delaware and ALI Defensive Tactics Rules to the Time-Warner Transaction

1. Description of Paramount's Tender Offer for Time and Time's Responsive Tender Offer for Warner

After the announcement of the originally proposed merger between Time and Warner, Paramount made a cash tender offer for Time. Paramount initially offered \$175 in cash per share and then raised the price to \$200.⁴⁴⁰ Before the first offer, Time's shares were trading for \$126. (On November 30, 1994 Time's shares traded for under \$34 per share.).

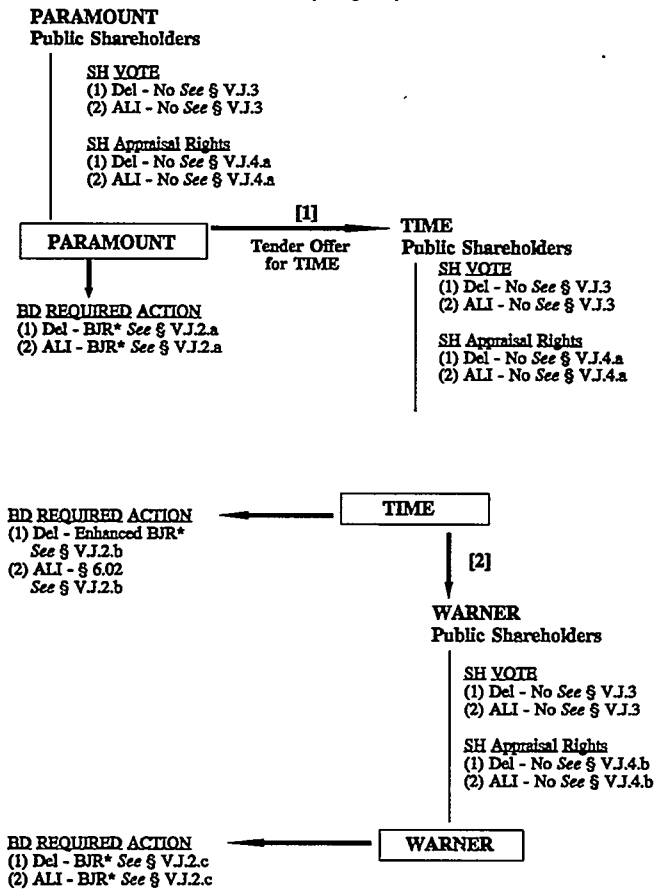
Time responded by terminating its merger agreement with Warner and entering into an agreement with Warner pursuant to which Time would make a tender offer at \$70 per share for Warner that would be followed up with a freezeout merger for the balance of the Warner shares.

The two tender offers are diagrammed on the following page:

⁴⁴⁰ Paramount Communications, Inc., Offer to Purchase Common Stock of Time, Inc., June 7, 1989, and June 23, 1989.

CHART B CASH TENDER OFFERS BY PARAMOUNT FOR TIME AND BY TIME FOR WARNER

(See § V.J)



* BUR means business judgment

2. Standards Governing Actions by Boards of Directors

a. Paramount's Board

Under Delaware law, the actions taken by Paramount's board of directors were governed by the Delaware business judgment rule. There appears to be no reported case in Delaware in which the directors of a corporation making a tender offer were denied protection under the business judgment rule.

Under the ALI rules, the duty of care of Section 4.01(a) and the business judgment rule of Section 4.01(c) would have been applicable to Paramount's board of directors. The directors appear to have clearly satisfied the conditions of the business judgment rule.

b. Time's Board

Under Delaware law, the first question to be addressed is whether the *Revlon* duty to auction applied to Time. The Delaware Supreme Court held, in *Paramount Communications, Inc. v. Time, Inc.*,⁴⁴¹ that *Revlon* was not implicated because there was no change of control of Time. The court found no change of control even though in the originally proposed merger, the Warner shareholders would have ended up owning 62% of the stock of Time. This holding is consistent with the rejection of the de facto merger doctrine in Delaware.

The court went on to hold, however, that since the tender offer for Warner was a device for blocking Paramount's tender offer for Time, the *Unocal* enhanced business judgment test applied. Under this test the Time directors had to establish that they had reasonable grounds for believing there was a danger to corporate policy and effectiveness and that their defensive tactics were reasonable in relation to the threat posed.

The court in *Paramount Communications, Inc. v. Time, Inc.* found that the Time's directors satisfied the *Unocal* enhanced business judgment test. Presumably the above conclusions are

⁴⁴¹ *Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140 (Del. 1990)

not disturbed by the Delaware Supreme Court's decision in *QVC Network Inc. v. Paramount Communications, Inc.*⁴⁴² In that case the court held that when a publicly held corporation (i.e., Paramount) is being acquired by a single controlling shareholder (i.e., Sumner Redstone), the directors of the target have a duty under *Revlon* to get the "best value reasonably available."⁴⁴³ This conclusion is buttressed by the Delaware Supreme Court's decision in *Arnold v. Society for Savings Bancorp, Inc.*,⁴⁴⁴ where the court said that *Revlon* duties apply:

At least in the following three scenarios: (1) when a corporation initiates an active bidding process seeking to sell itself or to effect a business reorganization involving a clear break-up of the company, [citing *Paramount v. Time*]; (2) where in response to a bidder's offer, a target abandons its long-term strategy and seeks an alternative transaction involving the break-up of the company, [*id.*]; or (3) when approval of a transaction results in a sale or change of control, [citing *QVC*.]⁴⁴⁵

Under the ALI rules, Section 6.02 would have applied to Time's tender offer for Warner, because the tender offer had the foreseeable effect of blocking Paramount's tender offer. Section 6.02 provides that a target's directors may take action that has a foreseeable effect of blocking an unsolicited tender offer if the action is a reasonable response. In making this determination consideration is given to whether the corporation's essential economic prospects are threatened and may be given to the impact on constituencies other than the target's shareholders as long as the shareholders are not significantly disfavored. Under Section 6.02(c), the burden of proof is on the plaintiff; therefore, the *Project* differs radically in this regard from Delaware law.

⁴⁴² 637 A.2d 34 (Del. 1993).

⁴⁴³ *Id.* at 43.

⁴⁴⁴ *Arnold v. Society for Savings Bancorp, Inc.*, 650 A.2d 1270 (Del. 1994).

⁴⁴⁵ *Id.* at 1289.

Under Section 6.02(d), if the business judgment rule of Section 4.01(c) is satisfied, then the target's directors have no personal liability.⁴⁴⁶

The *Project* indicates that the application of Section 6.02 to the Time tender offer for Warner would have resulted in the same conclusions reached as in *Paramount Communications, Inc. v. Time, Inc.*⁴⁴⁷

The *Project* does not adopt the *Revlon* duty to auction concept.

c. Warner's Board

Warner was the target of Time's tender offer, but Warner was not subject to an unwanted tender offer. Consequently, the *Unocal* enhanced business judgment rule did not apply to Warner and, therefore, the basic business judgment rule was applicable.

Also, the *Revlon* auction rule did not apply to Warner; however, if another bidder for Warner had surfaced, Warner, as a company undergoing a change of control resulting from the tender offer, would have been subject to *Revlon* auction duties.

Under the ALI rules, Warner was not taking any action that had the foreseeable effect of blocking an unsolicited tender offer and, therefore, Section 6.02 would not have been implicated. Consequently, Warner's board would have been subject to the business judgment rule of Section 4.01(c). The *Revlon* duty is not adopted by the *Project*.

3. Shareholders Voting

The shareholders of Paramount, Time and Warner did not have the right to vote under Delaware Law and would not have such rights under the ALI *Project*.

⁴⁴⁶ 1 ALI CORPORATE GOVERNANCE PROJECT, *supra* note 1, § 6.02 cmt. d, at 424.

⁴⁴⁷ *Id.* cmt. c(6), illus. 5, at 417-18 and reporter's note 3, at 430.

4. Appraisal Rights in Paramount's Tender Offer for Time and in Time's Tender Offer for Warner
 - a. Time's and Paramount's Shareholders as Acquiror Shareholders

Delaware law does not give appraisal rights to the shareholders of the acquiror in a tender offer, and therefore, no appraisal rights arose in Paramount's tender offer for Time or in Time's tender offer for Warner. This denial of appraisal rights applies in both cash tender offers and in exchange offers in which the acquiror issues its stock in exchange for stock of the target pursuant to a tender offer.

If the acquiror does not have a sufficient number of authorized, but unissued, shares to issue shares in an exchange offer, the shareholders of the acquiror would have to vote to increase the number of authorized shares, but no appraisal rights would arise.

The ALI rules generally do not provide for appraisal rights in a tender offer, and this general rule governs both Paramount's cash tender offer for Time and Time's cash tender offer for Warner.

Under Section 7.21(a), appraisal rights would, however, apply to an acquiror in an exchange offer that issued more than 40% of its stock in exchange for stock of the target. In such case, the 60% continuity requirement of Section 7.21(a) would not be satisfied. The *Project* explains this rule as follows:

[A]n exchange offer in which the tendering company issues more than 40% of its own voting stock to new holders would trigger appraisal rights for the tendering corporation's shareholders, but not for those of the target, because in the latter case there has been no "exchange by the corporation of its stock" under § 7.21(a).⁴⁴⁸

⁴⁴⁸ 2 ALI CORPORATE GOVERNANCE PROJECT, *supra* note 1, § 7.21 cmt. c(1), at 304.

b. Warner's Shareholders

Delaware law does not give appraisal rights to the shareholders of the target of a tender offer.

The ALI rules do not give appraisal rights to the shareholders of a target of a tender offer. The *Project* rejected a proposal to provide appraisal rights for a target's shareholders in a tender offer that resulted in the target no longer (a) being a listed company, or (b) having 300 shareholders.⁴⁴⁹

K. Observations

The bottom line is that Section 6.02 gives the target's directors wide discretion in defending against a hostile tender offer. It would appear that a target's directors would lose the protection of Section 6.02 only in an egregious circumstance.

The *Project* says that "there will be some sets of facts where the board will not be able to block [a] tender offer and satisfy the requirement of § 6.02."⁴⁵⁰ Unfortunately, the *Project* does not give an illustration of such a set of facts.

In its recent decision in *American General Corp. v. Unitrin, Inc.*,⁴⁵¹ the Delaware Chancery court found that there was a reasonable probability that a target's board violated its *Unocal* duties in implementing a stock repurchase program but that the board satisfied those duties in implementing a poison pill in response to the acquiror's offer. The court reasoned that "Unitrin's board believed in good faith that the offer was inadequate, and employed a poison pill to protect its shareholders from a 'low ball' bid."⁴⁵² On the other hand, the court found that the repurchase program was "designed to keep the decision to combine with American General within the control of the members of the board [and, therefore,] fails to meet the proportionality requirement of the *Unocal* test."⁴⁵³ The court's deci-

⁴⁴⁹ *Id.* reporter's note 3, at 312-13.

⁴⁵⁰ 1 ALI CORPORATE GOVERNANCE PROJECT, *supra* note 1, § 6.02 cmt. c(8), at 420.

⁴⁵¹ 1994 WL 698483 (Del. Ch. 1994).

⁴⁵² *Id.* at *8.

⁴⁵³ *Id.*

sion in *Unitrin* appears to be soundly reasoned. It would appear that the same result would be reached under Section 6.02.

VI. SALE BY CONTROLLING SHAREHOLDERS OF STOCK OF TARGET TO THIRD PARTY

A. The Rules

Section 5.16 addresses the sale by a target's controlling shareholder of its controlling stock interest to a third party, with the target's other shareholders not participating in the sale. This transaction is the opposite of a freezeout. Rather than purchasing the shares of the minority shareholders, the controlling shareholder sells his own shares.

Under Section 5.16 the controlling shareholder has, subject to the caveats noted below, the same right to dispose of its shares as any other shareholder and may dispose of its shares for "a price that is not made proportionately available to other shareholders"⁴⁵⁴ Thus, the controlling shareholder has the right to a control premium on the sale of its shares. Under Section 5.16, this right of disposition violates the duty of fair dealing to the other shareholders if either

(a) The controlling shareholder does not make disclosure concerning the transaction [§ 1.14(b)] to other shareholders with whom the controlling shareholder deals in connection with the transaction; or

(b) It is apparent from the circumstances that the purchaser is likely to violate the duty of fair dealing . . . in such a way as to obtain a significant financial benefit for the purchaser or an associate [§ 1.03].⁴⁵⁵

The *Project* explains that the disclosure exception in Section 5.16(a) is directed at selling controlling shareholders who help persuade minority shareholders to sell at a lower price than that at which the controlling shareholder sells.⁴⁵⁶ The duty of

⁴⁵⁴ 1 ALI CORPORATE GOVERNANCE PROJECT, *supra* note 1, § 5.16.

⁴⁵⁵ *Id.*

⁴⁵⁶ *Id.* § 5.16 cmt. d, at 376.

disclosure only extends to shareholders with whom the controlling shareholder deals, and therefore, "Section 5.16(a) is . . . consistent with the announced rule in *Brown v. Halbert*, 271 Cal. App. 2d 252, 76 Cal. Rptr. 781(1969), although it does not follow dicta in that opinion more broadly supportive of an equal opportunity approach."⁴⁵⁷ Section 5.16(a) does not prevent a controlling shareholder who rejects an offer to buy all the corporation's outstanding shares at one price from then offering its own shares at a higher price.⁴⁵⁸

The exception in Section 5.16(b) relating to likelihood of a violation of the duty of fair dealing is consistent with such cases as *Clagett v. Hutchinson*⁴⁵⁹ and *Swinney v. Keebler Co.*⁴⁶⁰ which hold generally that a controlling shareholder cannot sell to a known looter.⁴⁶¹ This exception applies because the selling controlling shareholder is in the "best position both to evaluate the risk and to prevent the transfer."⁴⁶²

The *Project* points out, however, that the controlling shareholder is not required to make an affirmative investigation "in the absence of facts that would alert a reasonable person to the need for further inquiry."⁴⁶³ Such inquiry is not required merely because the purchaser has a "general reputation for aggressive acquisitions."⁴⁶⁴ Rather, inquiry is necessitated by facts sufficient to put the controlling shareholder "on notice that it would be imprudent to proceed with the transaction without making further inquiry as to the purchaser and its motives for acquiring control of the corporation."⁴⁶⁵ The burden of proof is on the challenging party.⁴⁶⁶

The *Project* explains that Section 5.16 follows the case law in generally rejecting an equal opportunity rule that would require

⁴⁵⁷ *Id.*

⁴⁵⁸ *Id.*

⁴⁵⁹ 583 F.2d 1259 (4th Cir. 1978).

⁴⁶⁰ 480 F.2d 573 (4th Cir. 1973).

⁴⁶¹ 1 ALI CORPORATE GOVERNANCE PROJECT, *supra* note 1, § 5.16 cmt. e, at 377.

⁴⁶² *Id.*

⁴⁶³ *Id.*

⁴⁶⁴ *Id.* at 378.

⁴⁶⁵ *Id.*

⁴⁶⁶ *Id.*

the controlling shareholder to share the control premium.⁴⁶⁷ The *Project* says that Section 5.16 is not inconsistent with control share statutes⁴⁶⁸ which require the approval of disinterested shareholders before control shares may be voted.⁴⁶⁹

The *Project* gives three possible explanations of a control premium: (1) the opportunity to exploit minority shareholders, (2) the differential in value between controlling and minority shares, and (3) efficiency gains resulting from the transfer of control.⁴⁷⁰ The *Project* points out that there is empirical evidence that at least in publicly held firms control premiums are not paid for the purpose of exploiting minority shareholders, and in any event, the fair dealing rules of the *Project* are designed to prevent any such exploitation.⁴⁷¹ Although the minority shareholders may not share in a control premium, assuming fair dealing, they will participate in any efficiency gains realized as a result of the change in control.⁴⁷²

The *Project* says that although "controlling shareholders often insist that any offer to acquire their shares be made available on the same terms to other shareholders, . . . failure of the controlling shareholder to seek equal treatment for other shareholders will not expose the controlling shareholder to liability . . .," absent non-disclosure or a knowing sale to a looter.⁴⁷³

Section 5.16 permits a transfer of control of a board of directors incident to a sale of a controlling stock interest. However, a "bare sale of office unaccompanied by a sale of controlling stock" is not permissible.⁴⁷⁴ Consequently, a transfer of the board is not permitted if a non-controlling shareholder who controls the board transfers control of the board in connection

⁴⁶⁷ *Id.* cmt. c, at 374 (citing, inter alia, *Zetlin v. Hanson Holdings, Inc.*, 397 N.E.2d 387 (N.Y. 1979) and *Clagget v. Hutchinson*, 583 F.2d 1259 (4th Cir. 1978)).

⁴⁶⁸ See, e.g., INDIANA CODE § 23-1-17-1 to 23-1-54-3 (1995 & Supp. 1996).

⁴⁶⁹ 1 ALI CORPORATE GOVERNANCE PROJECT, *supra* note 1, § 5.16 cmt. c, at 374.

⁴⁷⁰ *Id.* at 374-75.

⁴⁷¹ *Id.* at 375.

⁴⁷² *Id.*

⁴⁷³ *Id.*

⁴⁷⁴ *Id.* cmt. f, at 379.

with a sale of stock at a premium.⁴⁷⁵ The transfer of control could be effectuated by the serial resignations of the old directors and the simultaneous appointment of the purchaser's nominees. In these types of sales of office, upon suit by a shareholder, the appointment of the purchaser's nominees is voidable and the selling shareholder must account for the premium. This principle is consistent with such cases as *Essex Universal Corp. v. Yates*⁴⁷⁶ and *In re Caplans' Petition*.⁴⁷⁷

B. Application of the Delaware and ALI Sale of Controlling Shares Rules to the Time-Warner Transaction

1. How a Hypothetical Sale of Controlling Shares Could Have Been Implicated

As a predicate to Time's tender offer for Warner, Time could have purchased shares of Warner from a controlling shareholder of Warner (it is assumed that such a shareholder existed only for purposes of this analysis) at a price above the price Time paid in the subsequent tender offer for the balance of Warner's stock. Such a transaction is not prohibited by the Williams Act amendments to the Securities Exchange Act of 1934 (Sections 13(d) and (e), and 14(d) and (e)) as long as the purchase of controlling shares is made prior to the commencement of the tender offer.

2. Treatment of a Hypothetical Sale of Controlling Shares of Warner to Time Prior to Tender Offer

Delaware law presumably follows the general rule which permits "controlling shareholders to sell their shares at a premium above the market price existing prior to disclosure of the transaction without . . . requir[ing] either that the premium be shared with other shareholders or that the transaction be restructured so that all shareholders [can] participate on the same terms."⁴⁷⁸ Thus, a sale of controlling shares in the cir-

⁴⁷⁵ *Id.*

⁴⁷⁶ 305 F.2d 572 (2d Cir. 1962).

⁴⁷⁷ 198 N.E.2d 908 (N.Y. App. Div. 1964).

⁴⁷⁸ 1 ALI CORPORATE GOVERNANCE PROJECT, *supra* note 1, § 5.16 cmt. c, at

cumstances described above probably would have been permitted under Delaware law.⁴⁷⁹

Under ALI Section 5.16, a controlling shareholder, as defined in Section 1.10, can sell his shares at a premium above that offered to the other shareholders as long as such shareholder makes a disclosure to other shareholders with whom he deals and it is not apparent that the purchaser is likely to violate the duty of fair dealing. Thus, the type of sale of a controlling interest described above likely would have been permitted under the ALI rules.

C. Observations

Section 5.16 correctly rejects the equal opportunity doctrine, and it correctly adopts the principle that a selling controlling shareholder cannot sell to a known looter. Both of these principles are consistent with the developing case law in this area, and there are no compelling reasons to move in a different direction.

Although an inquiry concerning the purchaser is not required, it would be prudent for a selling controlling shareholder to refuse to sell unless, on the basis of a due diligence investigation, it concludes that there is no reason to believe the purchaser will violate its duties of fair dealing.

VII. NON-MAJORITY CONTROL AND MAJORITY CONTROL FREEZEOUTS

A. Introduction

Freezeouts or squeezeouts involve situations in which a shareholder, usually a parent corporation, that owns a controlling stock interest in a subsidiary corporation (target) acquires all of the stock or assets of the target in a merger, liquidation or sale of assets transaction. The transaction can take many forms, including a merger of the target with a wholly-owned

374.

⁴⁷⁹ See *Rabkin v. Olin Corp.*, 1990 WL 47648 (Del. Ch. 1990).

subsidiary of the parent. After the dust settles, the controlling parent holds either directly or indirectly all of the target's stock or assets, and the target's minority shareholders have been cashed out or have received securities in the parent.

The *Project* divides freezeout transactions into two broad categories: First, transactions in which the controlling shareholder is not the majority shareholder of the target (i.e., non-majority control freezeouts), and second, transactions in which the controlling shareholder is the majority shareholder of the target and, therefore, can unilaterally effectuate the freezeout transaction without the vote of the minority shareholders (i.e., majority control freezeouts). This latter category includes situations in which a controlling corporate shareholder owns a sufficient stock interest in the target to effectuate a short-form merger (usually 90% or 95%).

Both of these transactions raise issues under the "duty of loyalty" which requires that directors, senior executives and controlling shareholders provide their "undivided and unselfish loyalty to the corporation"⁴⁸⁰ The *Project* refers to this duty of loyalty as a duty of fair dealing and provides in Section 5.01: "Directors [§ 1.13], senior executives [§ 1.33], and controlling shareholders [§ 1.10], when interested [§ 1.23] in a matter affecting the corporation, are under a duty of fair dealing. . . ."⁴⁸¹

Generally this duty of fair dealing is satisfied under Section 5.02 if the conflict of interest is disclosed and the transaction is either fair to the corporation when entered into or approved by disinterested directors or disinterested shareholders.

Non-majority control freezeouts, which are addressed in Section VII.B.4 below, are subject to the fair dealing standards in Section 5.10, and the appraisal remedy is not exclusive.⁴⁸² The majority control freezeout is also subject to the fair dealing standards of Section 5.10; however, appraisal is the exclusive remedy if the conditions in Section 7.25 are satisfied.⁴⁸³ Non-

⁴⁸⁰ 1 ALI CORPORATE GOVERNANCE PROJECT, *supra* note 1, § 5.01 reporter's note 1, at 206 (quoting *Guth v. Loft, Inc.*, 5 A.2d 503, 510 (Del. 1939)).

⁴⁸¹ *Id.* § 5.01.

⁴⁸² *Id.* § 5.15 cmt. c, at 365. See also *id.* § 3.74 cmt. c, at 351 and § 7.25 cmt. c, at 384. See *infra* Part VII.B.4.

⁴⁸³ 2 ALI CORPORATE GOVERNANCE PROJECT, *supra* note 1, § 7.24 cmt. c, at

majority control freezeouts are addressed in Section VII.B, and majority control freezeouts are taken up in Section VII.C.

If the controlling shareholder disposes of its interest in the target and has no interest in the acquiring corporation, then the fair dealing principles are not implicated. This is so even if the controlling shareholder receives a control premium, unless, as provided in Section 5.16⁴⁸⁴ no disclosure is made or the sale is to a person who is likely to violate the duty of fair dealing. If the disposition by the controlling shareholder is made in a transaction in which the appraisal remedy is provided, then under Section 7.24 appraisal is the exclusive remedy. If the controlling person has an interest in the acquiring entity that causes such controlling person to be interested in the transaction, within the meaning of Section 1.23 of the *Project*, then the transaction is subject to the management buyout rules of Section 5.15.

B. Non-Majority Control Freezeouts

1. Introduction

Non-majority control freezeouts are subject to the fair dealing standards of Section 5.10. It should first be pointed out, however, that if a parent owns less than a majority of the stock of a subsidiary, the presence of disinterested directors on the subsidiary's board "may lead [a] court to conclude that [the subsidiary] is not controlled"⁴⁸⁵ In this situation the fair dealing standards of Section 5.10 are not applicable.⁴⁸⁶

Under Section 5.10(a), the controlling shareholder fulfills its duty of fair dealing in one of two ways. First, under Section 5.10(a)(1), the duty is satisfied if the transaction is fair to the corporation when entered into. Second, under Section 5.10(a)(2), the duty is satisfied if the following two conditions are met. First, the transaction is authorized or ratified by disinterested

351 and § 7.25 cmt. c, at 384. See *infra* Part VII.C.2.c.

⁴⁸⁴ See *infra* Part VI.

⁴⁸⁵ 1 ALI CORPORATE GOVERNANCE PROJECT, *supra* note 1, § 5.10 cmt. e, at 330.

⁴⁸⁶ *Id.*

shareholders following disclosure concerning the conflict of interest and the transaction. Second, the transaction does not constitute a waste of corporate assets at the time of shareholder action. Thus, the duty of fair dealing is satisfied by either a fairness standard or a waste standard.

Under Section 5.10(b), which applies to non-ordinary course transactions, if after disclosure, the transaction is authorized in advance by disinterested directors or authorized or ratified by disinterested shareholders, the challenging party has the burden of proof. Thus, if the conditions of Section 5.10(a)(2) are satisfied, the challenging party must prove that the transaction amounts to a waste of corporate assets, not that the transaction was merely unfair. The challenging party also has the burden if the transaction was ratified by disinterested directors and the failure to get their prior approval "did not adversely affect the interests of the corporation in a significant way."⁴⁸⁷ The controlling shareholder has the burden of proof if the transaction was not so authorized or ratified.⁴⁸⁸

Thus, in a non-majority control freezeout, the controlling parent has three practical avenues. First, complete the transaction without getting prior approval of disinterested directors or disinterested shareholders, in which case the controlling parent has the burden of proving that the transaction is fair.⁴⁸⁹ Second, make full disclosures concerning the conflict of interest and the transaction and obtain the prior approval of disinterested shareholders (whether or not prior approval is received from disinterested directors), in which case the challenging party has the burden of proving that there was a waste of corporate assets.⁴⁹⁰ Third, make full disclosure of the conflict of interest and the transaction, obtain the approval of disinterested directors (but not the approval of disinterested shareholders), in which case the challenging party has the burden of proving that the transaction is unfair.⁴⁹¹ These rules can be diagrammed as follows:

⁴⁸⁷ *Id.* at § 5.10(b).

⁴⁸⁸ *Id.* at § 5.10(b) and (c).

⁴⁸⁹ *Id.* at § 5.10(a)(1).

⁴⁹⁰ *Id.* at § 5.10(a)(2) and (b).

⁴⁹¹ *Id.* at § 5.10(a)(1), (a)(2) and (b).

TABLE 1
ILLUSTRATION OF SECTION 5.10

[1] Full Disclosure of Conflict of Interest and of Transaction	[2] Approval of Disinterested Directors	[3] Approval of Disinterested Shareholders	[4] Fairness Review	[5] Waste Standard	[6] Burden on Controlling Parent	[7] Burden on Challenging Party
1. No	No	No	Yes	No, § 5.101(a)(2) not applicable	Yes	No
2. Yes	?	Yes	No	Yes, See § 5.10(a)(2)	No	Yes, See § 5.10(b)
3. Yes	Yes	No	Yes	No, § 5.10(a)(2) not applicable	No	Yes, See § 5.10(b)

2. No Disclosure Needed Before Transaction Subject to Fairness Standard

The *Project* says that although in the

usual course of dealing between a controlling shareholder and the corporation, the controlling shareholder is not required to undertake the disclosure of material facts with respect to the conflict of interest and the transaction . . . , [a]s a matter of corporate practice . . . a controlling shareholder should make disclosure when dealing with the board of the [controlled] corporation.⁴⁹²

As a practical matter in a non-majority control freezeout, disclosure will have to be made in order to obtain a sufficient vote of the shareholders, even though the transaction is not approved by disinterested shareholders. Even if a vote of shareholders is not required, Section 14(c) of the Securities Exchange Act of 1934 would likely require full disclosure.

3. Proof of Fairness

Under Section 5.10(a), the transaction must be fair, unless full disclosure is made and the approval of disinterested shareholders is obtained.⁴⁹³ The controlling parent corporation has the burden of proving fairness, unless full disclosure is made and the approval of disinterested directors (but not of disinterested shareholders) is obtained, in which case the burden of proof is on the challenging party.⁴⁹⁴ Fairness is established if it is shown that the transaction falls within a range of reasonableness.⁴⁹⁵

The *Project* says that if the controlling parent has attempted to "approximate an arm's length transaction by providing independent representation of the controlled corporation in the

⁴⁹² *Id.* § 5.10 cmt. d, at 327.

⁴⁹³ See Table 1.

⁴⁹⁴ See *id.*

⁴⁹⁵ 1 ALI CORPORATE GOVERNANCE PROJECT, *supra* note 1, § 5.10 cmt. e, at 329.

negotiations[,] . . . court[s] should give substantial weight to the judgment of disinterested directors of the controlled corporation⁴⁹⁶ In support of this proposition the Project refers to the Delaware Supreme Court's decision in *Weinberger v. UOP, Inc.*⁴⁹⁷ That case involved the acquisition by a controlling parent (Signal) of all of the stock of its partially owned subsidiary (UOP) in a freezeout transaction. The *Project* says that the following excerpt from the *Weinberger* opinion is of particular relevance:

Although perfection is not possible, or expected, the result here could have been entirely different if UOP [the subsidiary] had appointed an independent negotiating committee of its outside directors to deal with Signal [the controlling parent] at arm's length [F]airness in this context can be equated to conduct by a theoretical, wholly independent, board of directors Particularly in a parent-subsidiary context, a showing that the action taken was as though each of the contending parties had in fact exerted its bargaining power against the other at arm's length is strong evidence that the transaction meets the test of fairness.⁴⁹⁸

The *Project* also says that a reviewing court should not give weight to an independent negotiating committee if it fails to provide effective representation or if the controlling shareholder consummates the transaction over the objection of the independent negotiating committee.⁴⁹⁹

The *Project* points out that although some cases recognize the duty of a controlling parent corporation to act in the interest of its shareholders, "[i]n the absence of total abstention by the common directors, or independent representation of the

⁴⁹⁶ *Id.* at 328.

⁴⁹⁷ *Id.* (citing *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983)).

⁴⁹⁸ *Id.* (citing *Weinberger*, 457 A.2d at 709 n.7).

⁴⁹⁹ 1 ALI CORPORATE GOVERNANCE PROJECT, *supra* note 1, § 5.10 cmt. e, at 328-29 (citing *Rabkin v. Philip A. Hunt Chemical Corp.*, 498 A.2d 1099 (Del. 1985)).

subsidiary by other directors, common directors must determine what is best for both the parent and the subsidiary."⁵⁰⁰

4. Appraisal Rights in Non-Majority Control Freezeouts

a. Availability of Appraisal Rights

Most non-majority control freezeouts will be effectuated by merger, such as a reverse subsidiary merger, and consequently, the shareholders of the target will have appraisal rights under Section 7.21(a). Even if the freezeout is effectuated in another form, such as by charter amendment or reverse stock split, appraisal rights will arise under Section 7.21(b).

b. Determining Fair Value in a Non-Majority Control Freezeout

(1) In General

A non-majority control freezeout is an interested transaction, and the same standards that apply for determining fair value in a management buyout also apply for determining fair value in a non-majority control freezeout.⁵⁰¹ Thus, under Section 7.22(c) in a non-majority control freezeout, the court "generally should give substantial weight to the highest realistic price that a willing, able, and fully informed buyer would pay for the corporation as an entirety."⁵⁰² This standard is discussed more fully in Section IV.C.2.

(2) Determining Fair Value in Two-Tier Offers

A non-majority control freezeout may be the second step of a two-tier tender offer. In two-tier tender offers, the front-end price normally will constitute the floor in a valuation proceed-

⁵⁰⁰ *Id.* at 330 (citing *Weinberger v. UOP, Inc.*, 457 A.2d 701, 710-11 (Del. 1983)).

⁵⁰¹ See *supra* Part IV.C.2.

⁵⁰² 2 ALI CORPORATE GOVERNANCE PROJECT, *supra* note 1, § 7.22(c).

ing regarding the back-end,⁵⁰³ absent material adverse changes to the target or a general market decline.⁵⁰⁴ The *Project* explains that this rule can help mitigate the effect of the pressure to tender the target's shareholders experience in a two-tier offer.⁵⁰⁵ This rule should not apply, however, in a private sale of control on the front-end.⁵⁰⁶ Also, in a two-tier "any and all" tender offer with the same price on both ends that is sanctioned by the target's board, there is little reason to permit a "minority shareholder who holds out to obtain a higher price than that received by the shareholders who tendered."⁵⁰⁷ The *Project* points out that these types of transactions are excepted from the SEC's going private rules under Rule 13e-3(g).⁵⁰⁸

The *Project* goes on to explain that in these "any and all" offers, the fair price "presumption created by Section 7.22(b) should apply, unless significant new factors not apparent at the time of the first transaction would make the same price inequitable."⁵⁰⁹ As discussed more fully in Section VII.C.2.c. (4), which deals with majority control freezeouts, in *Cede & Co. v. Technicolor, Inc.*⁵¹⁰ the Delaware appraisal court did not accept this fair price assumption and found that the appraised price in the back-end freezeout was \$21.60 per share even though the front-end tender offer price was \$23.

c. Non-Exclusivity of Appraisal Proceeding for
Non-Majority Control Freezeouts

Section 7.24, which sets out the general rules regarding the exclusivity of appraisal proceedings, provides that exclusivity is not available for a freezeout transaction under Section 5.10. Also, Section 7.24 does not apply to a transaction under Section

⁵⁰³ *Id.* § 7.22 cmt. f, at 328-29.

⁵⁰⁴ *Id.*

⁵⁰⁵ *Id.* at 328.

⁵⁰⁶ *Id.* at 329.

⁵⁰⁷ *Id.*

⁵⁰⁸ *Id.*

⁵⁰⁹ *Id.* at 329-30.

⁵¹⁰ 1990 WL 161084 (Del. Ch. 1990).

7.25, which provides that appraisal is the exclusive remedy for certain majority control freezeouts. Thus, appraisal is not the exclusive remedy for (1) non-majority control freezeouts under Section 5.10 and (2) majority control freezeouts under Section 5.10 that do not satisfy the conditions of Section 7.25.⁵¹¹

Consequently, in a non-majority control freezeout the challenging Party can challenge the transaction on the grounds of either fairness or waste of corporate assets. The waste standard applies if the controlling parent complies with Section 5.10(a)(2) in making full disclosure and receiving approval of disinterested shareholders. As indicated in the discussion of fairness in Section VII.B.3, if the controlling parent utilizes an independent negotiating structure in determining the freezeout price, courts should give "substantial weight" to the judgment of disinterested directors concerning the fairness of the price. Consequently, as a practical matter if such an independent structure is utilized and the disinterested shareholders approve the transaction, a dissenting shareholder would unlikely be successful in establishing either a waste of corporate assets or an appraisal fair value that exceeded the freezeout price.

It would appear that appraisal would only be an effective remedy if the controlling parent unilaterally effectuated the freezeout, in which case the parent would have the burden of establishing fairness under Section 5.10(a)(1), and the freezeout consideration would not be convincing evidence of fair value in an appraisal proceeding. As a practical matter, if the parent acts unilaterally, there probably will not be an appraisal proceeding because the fairness proceeding will likely be more advantageous to shareholders, and all shareholders, not just those who dissent, would participate.

⁵¹¹ See *infra* Part VII.C.2.c.

C. Majority Control Freezeouts

1. Introduction

Majority control freezeouts (i.e., freezeouts where the parent has sufficient votes to effectuate the transaction itself) are subject to the rules of Section 5.10, which also apply to non-majority control freezeouts, unless the transaction satisfies the requirements of Section 7.25, which provides that appraisal is the exclusive remedy. Consequently, in this type of transaction the parent corporation has under Section 5.10(a)(1) the burden of proving that the transaction is fair, unless full disclosure is made and the transaction is approved by disinterested shareholders, in which case under Section 5.10(a)(2) and (b) the challenging party has the burden of proving a waste of corporate assets. If disclosure is made and the transaction is approved by disinterested directors, but not disinterested shareholders, the challenging party has under Section 5.10(a)(1) and (b) the burden of proving that the transaction was not fair.⁵¹²

Section 7.25 provides a mechanism for avoiding the above rules and making appraisal the exclusive remedy for challenging a majority-control freezeout.⁵¹³ Under Section 7.25(d), this provision is only available to publicly held corporations. The Reporter's Notes explain that freezeouts of closely-held corporations "have often been found wrongful by the courts absent a strong justification."⁵¹⁴

2. Appraisal Rights in Majority Control Freezeouts

a. Availability of Appraisal Rights

As in the case of non-majority control freezeouts, appraisal rights will arise in majority control freezeouts under the merger

⁵¹² See *supra* Table 1.

⁵¹³ See *infra* Part VII.C.2.c.

⁵¹⁴ 2 ALI CORPORATE GOVERNANCE PROJECT, *supra* note 1, § 7.25 reporter's note 2, at 391 (citing *Sugarman v. Sugarman*, 797 F.2d 3 (1st Cir. 1986)).

rule of Section 7.21(a) or the general freezeout rule of Section 7.21(b).⁵¹⁵ Appraisal rights would clearly arise in any short-form merger, that is a merger which can be approved solely by a parent corporation that owns at least 90 or 95% of the stock of the merging subsidiary.

b. Determining Fair Value in a Majority Controlled Freezeout

A majority controlled freezeout, like a non-majority control freezeout, is an interested party transaction, and consequently, the Section 7.22(c) "highest realistic price standard" that applies for minority control freezeouts also applies for majority control freezeouts.⁵¹⁶ Also, in two tier offers the same standards apply for determining fair value in non-majority and majority control freezeouts.⁵¹⁷

c. Exclusivity of Appraisal Proceedings for Certain Majority Control Freezeouts

(1) In General

Section 7.25(a) provides that an appraisal proceeding is a challenging party's exclusive remedy to a transaction in control involving a corporate combination in which a controlling shareholder is a party, if the controlling shareholder holds sufficient voting shares of the target to approve the transaction and the following four conditions are satisfied.

First, under Section 7.25 (a)(1), the target's directors (or the parent's directors, if the target's directors are not required to approve the transaction, such as with a short form merger) must have an "adequate basis, grounded on substantial objective evidence, for believing that the consideration offered to the minority shareholders in the transaction constitutes fair value

⁵¹⁵ See *supra* Part VII.B.4.a.

⁵¹⁶ See *supra* Part VII.B.4.b.

⁵¹⁷ See *supra* Part VII.B.4.b.ii.

for their shares"⁵¹⁸ This requirement is explored in greater detail below. Second, under Section 7.25(a)(2), disclosure must be made to minority shareholders concerning the transaction, the basis for the determination of fair value, the conflict of interest and the availability of appraisal rights. Third, under Section 7.25(a)(3), the transaction must comply with all applicable laws and the target's charter documents. Fourth, under Section 7.25(a)(4), the target's shareholders who do not vote to approve the transaction must be entitled to an appraisal remedy that is consistent with the principles embodied in Sections 7.22 and 7.23.

If the four conditions are not satisfied so that the transaction falls outside of Section 7.25, then the transaction is subject to Section 5.10, as discussed in Section VII.B.1 above, and appraisal will not be the exclusive remedy.⁵¹⁹

Section 7.25 applies to all forms of majority controlled freeze-out transactions, including transactions in which the minority shareholders receive cash (i.e., cash outs) and those in which the minority shareholders receive securities.⁵²⁰ It applies to various types of mergers, including triangular mergers with controlled subsidiaries of the controlling shareholder and short-form mergers, that is mergers in which the target's shareholders do not have the right to vote.⁵²¹

The *Project* explains that there are three reasons for making appraisal the exclusive remedy in these situations. First, the freezeout is likely to promote efficiency by eliminating the need to scrutinize intercorporate dealings between the parent and the target.⁵²² Second, the fair expectations of minority shareholders probably are not violated.⁵²³ This was not the situation, however, in the *New England Patriots* case⁵²⁴ which is

⁵¹⁸ 2 ALI CORPORATE GOVERNANCE PROJECT, *supra* note 1, § 7.25(a)(1).

⁵¹⁹ *Id.* § 7.25 cmt. c, at 384-85.

⁵²⁰ *Id.* at 383.

⁵²¹ *Id.*

⁵²² *Id.*

⁵²³ *Id.*

⁵²⁴ *Coggins v. New England Patriots Football Club, Inc.*, 592 N.E.2d 1112 (Mass. 1986).

discussed in Section VII.C.3 below. Third, if the majority shareholder is a corporation, a "freezeout at a fair price is supported by analogy to the short-form merger statutes."⁵²⁵

The controlling shareholder must not just be the majority shareholder, it must possess sufficient voting power under the applicable state law and the corporate charter to unilaterally effectuate the transaction.⁵²⁶

Under Section 7.25(b), the controlling shareholder has the burden of proving compliance with the above four conditions, unless after full disclosure, the transaction was approved in advance by disinterested directors and either approved in advance or ratified by disinterested shareholders. Consequently, the parent can place on the challenging party the burden of proving non-compliance with the conditions for exclusivity by setting up an independent negotiating structure and receiving approval of the disinterested shareholders. This applies in both long-form and short-form mergers.

Under Section 7.25(c), if (1) all of the conditions for exclusivity are present, except that there is no appraisal remedy for dissenters, and (2) after disclosure, the transaction is approved by disinterested shareholders, then the transaction may be challenged on the grounds that it is not fair, and the challenging party has the burden of proof. In such situations, if the approval of disinterested directors is not received, the parent has the burden of proof that the transaction was fair. If disinterested director approval is received, following *Weinberger*, courts should give substantial weight to their judgment.⁵²⁷

If the controlling shareholder does not have an equity interest in the surviving entity and the transaction is not subject to the management buyout provisions of Section 5.15, then the fair dealing principles of Section 5.10 are not implicated and an appraisal proceeding is the exclusive remedy under Section 7.24.

⁵²⁵ 2 ALI CORPORATE GOVERNANCE PROJECT, *supra* note 1, § 7.25 cmt. c, at 383.

⁵²⁶ *Id.* at 384.

⁵²⁷ *Id.* at 387-88.

(2) Reasonable Belief of Directors as to Fair Value

The first condition for exclusivity is that the directors who propose the freezeout on behalf of the controlled corporation have "an adequate basis, grounded on substantial objective evidence, for believing that the consideration offered to the minority shareholders in the transaction constitutes fair value for their shares, as determined in accordance with the standards provided in § 7.22."⁵²⁸ Section 7.22(a) provides that fair value is to be "determined [by] using the customary valuation concepts and techniques generally employed in the relevant securities and financial markets for similar businesses in the context of the transaction giving rise to appraisal."⁵²⁹

The *Project* says that in determining whether a board's determination of the fair value of minority shares is "grounded on substantial objective evidence," a court need not conduct a full review of fair value as would occur in an appraisal proceeding.⁵³⁰ Courts should focus on the following two inquiries:

(1) [W]hether, through procedures that would as a matter of practice normally be employed in arm's-length transactions with third parties, the corporate decision-maker [§ 1.11] has caused to be developed, and independently evaluated, reliable evidence of the fair value of its shares as determined in accordance with the standards provided in § 7.22; and (2) whether this evidence is an adequate basis for the determination that the consideration offered to the minority shareholders in the transaction constitutes fair value for their shares.⁵³¹

If an independent negotiating structure is not feasible in a short-form merger, the absence of such a structure will not prevent the parent from establishing objective evidence through other means.⁵³²

⁵²⁸ *Id.* § 7.25(a)(1).

⁵²⁹ *Id.* § 7.22(a).

⁵³⁰ *Id.* § 7.25 cmt. c, at 385.

⁵³¹ *Id.*

⁵³² *Id.* at 385-86.

The *Project* says, however, that the use of independent negotiating committees should be encouraged in transactions subject to Section 7.25 and that "a court reviewing the price to be paid in an appraisal proceeding should be entitled to give considerable weight to a price arrived at through what approximates an arm's-length negotiation"⁵³³ On the other hand, if an independent negotiating structure is not used, the "price that would be offered by a third party to acquire the entire corporation would be persuasive evidence of fair value."⁵³⁴

If a court concludes that this adequate basis standard is not met, then the court "normally should grant injunctive relief."⁵³⁵

(3) Disclosure Requirement

Under Section 7.25(a)(2), full disclosure to the minority shareholders is required whether or not proxies are solicited.⁵³⁶ Thus, Section 7.25(a)(2) is consistent with Section 14(c)⁵³⁷ and Regulation 14C⁵³⁸ of the Securities Exchange Act of 1934, which require the distribution of an information statement to minority shareholders concerning a freezeout transaction even if they do not have the right to vote on the transaction. The *Project* indicates that such disclosure is required to allow the minority shareholders to determine whether to exercise their appraisal rights.⁵³⁹

The directors would have to disclose both that they are of the view that the consideration offered to the minority shareholders represents fair value for the shares and the basis for that view.⁵⁴⁰ The *Project* indicates that this type of disclosure is similar to that required by Item 8(a) of Schedule 13E-3,

⁵³³ *Id.* at 388.

⁵³⁴ *Id.*

⁵³⁵ *Id.* at 386.

⁵³⁶ *Id.*

⁵³⁷ 15 U.S.C. § 78n(c) (1976).

⁵³⁸ 17 C.F.R. § 240.14c-1-7 (1995).

⁵³⁹ 2 ALI CORPORATE GOVERNANCE PROJECT, *supra* note 1, § 7.25 cmt. c, at 386.

⁵⁴⁰ *Id.*

which applies in going private transactions. Item 8(a) requires the controlling person to state whether the transaction is fair or unfair and to discuss in "reasonable detail the material factors upon which the belief [concerning fairness] is based."⁵⁴¹

Disclosure is to be made concerning any independent negotiating structure and the effectiveness of such structure in producing a price based on arm's length negotiations.⁵⁴²

(4) Two Step Transactions

Section 7.25 does not prevent a majority shareholder from purchasing in the open market shares held by minority shareholders. Also Section 7.25 does not prevent an acquiring person from becoming a controlling shareholder through "open market purchases or a tender offer."⁵⁴³ However, in the appraisal proceedings pursuant to a second step merger transaction, occurring within a reasonable period of time after the initial purchases, the price paid in the open market purchase or in the first step stock purchase would be "presumed to be the best evidence of the minimum fair value of the remaining shares, absent a clear showing of an intervening change in the financial condition of the corporation or a general change in the economy or in the industry in which the corporation operates which affects share values."⁵⁴⁴ The strength of the presumption should diminish with time and the occurrence of economic changes; however, to prevent the structuring of "disguised" two step offers, the *Project* does not suggest any specific period of time for linking the steps.⁵⁴⁵

The *Project* says that in addition to promoting the proper valuation in an appraisal proceeding, this concept of looking at the price paid in the first step "serves to reduce any coercive

⁵⁴¹ Schedule 13E-3, 17 C.F.R. § 240.13e-100 (1995).

⁵⁴² 2 ALI CORPORATE GOVERNANCE PROJECT, *supra* note 1, § 7.25 cmt. c, at 386.

⁵⁴³ *Id.* at 388.

⁵⁴⁴ *Id.* at 389.

⁵⁴⁵ *Id.*

effect of first-step offers on target shareholders by assuring non-tendering shareholders of something approaching, but not necessarily equaling, that price in a second-step freezeout.⁵⁴⁶ Thus, this valuation principle is designed to deter an acquiring firm from balancing an overpayment in the first-step with an underpayment in the second-step freezeout.⁵⁴⁷

The *Project* may overestimate the anti-coercive effect of this valuation principle because only dissenting shareholders would get the benefit of the higher appraisal price. Those minority shareholders who decide not to dissent must accept the price offered, which could be much less than both the front-end price and the appraisal price.

The position taken by the *Project* to the effect that the price in the first step should generally be presumed to be the best evidence of a fair price in an appraisal proceeding relating to the second step was not followed in *Cede & Co. v. Technicolor, Inc.*⁵⁴⁸ There, the Delaware appraisal court found that the fair value of a target's shares in a second-step freezeout merger was only \$21.60 per share, even though the price paid in the first-step tender offer, which occurred shortly before the freeze-out, was \$23 per share.

(5) Illustrations

The *Project* illustrates the principles under Section 7.25 by reference to facts that are similar to those in *Rabkin v. Philip A. Hunt Chemical Corp.*,⁵⁴⁹ which is discussed in the next section. The basic facts indicate that the acquiring corporation purchases 63% of the target's stock for \$25 per share and agrees in the purchase agreement that if the acquiring corporation acquires any of the target's minority shares within a year it will pay at least \$25 per share. Full disclosure of the terms of the transaction is made to the target's minority shareholders. After the lapse of the one year period, the acquiror proposes to

⁵⁴⁶ *Id.*

⁵⁴⁷ *Id.*

⁵⁴⁸ 1990 WL 161084 (Del. Ch. 1990)

⁵⁴⁹ 498 A.2d 1099 (Del. 1985).

acquire the minority shares which have been trading at \$20 on the open market. A committee of outside directors of the target evaluates the offer and receives an opinion of an investment banking firm to the effect that the remaining shares are worth between \$19 and \$23 per share. The committee and the acquiring corporation enter into a merger agreement calling for the payment of \$21 per share in cash to the minority shareholders. The transaction is effectuated without the approval of the target's minority shareholders, but full disclosure is made as required by Section 7.25(a)(2). The merger agreement complies fully with law and the target's shareholders are given an appraisal remedy. The illustration holds that appraisal is the exclusive remedy.⁵⁵⁰

In another example, the facts are the same as above, except that at the time the acquiring corporation purchases 63% of target's stock, it fully intended to wait a year and then acquire the minority shares for \$18 per share. The acquiring corporation considered the extra \$7 per share paid for the 63% to be a control premium. Presumably the independent negotiating structure is adopted and the transaction is effectuated at \$21 per share as indicated above. The illustration holds that although appraisal is still the exclusive remedy for the minority shareholders, they have a cause of action against the acquiring corporation for failure to disclose its intention. The minority shareholders may not, however, claim the control premium, which is permitted under Section 5.16.⁵⁵¹

3. Existing Law

The *Project* points out that several cases have limited the power of a controlling shareholder to freezeout minority shareholders, particularly in the absence of a business purpose.⁵⁵²

⁵⁵⁰ 2 ALI CORPORATE GOVERNANCE PROJECT, *supra* note 1, § 7.25 cmt. c, illus. 1, at 389-90.

⁵⁵¹ See *supra* Part VI.

⁵⁵² 2 ALI CORPORATE GOVERNANCE PROJECT, *supra* note 1, § 7.25 cmt. a, at 382.

Although this approach had previously been taken in Delaware in such cases as *Singer v. Magnavox Co.*,⁵⁵³ and *Tanzer v. International General Industries, Inc.*,⁵⁵⁴ in *Weinberger v. UOP, Inc.*,⁵⁵⁵ the Delaware Supreme Court abandoned the business purpose requirement. Citing *Rabkin v. Philip A. Hunt Chemical Corp.*,⁵⁵⁶ the *Project* points out that the "standards in Delaware as to the scope of judicial review of such transactions are continuing to evolve."⁵⁵⁷

In *Rabkin*, the acquiring corporation, Olin, purchased 63.4% of the stock of the target, Hunt Chemical for a price of \$25 per share. The stock purchase agreement provided that if Olin purchased all or substantially all of the remaining Hunt shares within one year from the date of the initial purchase, Olin would have to pay the minority shareholders the same \$25 price it paid initially. Approximately four weeks after the running of the one year period, Olin's board approved a freezeout transaction in which Hunt shareholders would receive \$20 per share. Two investment banking firms issued opinions that the price was fair. Holding that under *Weinberger* appraisal was the exclusive remedy, the Chancery Court rejected the claims of minority shareholders that the price offered was grossly inadequate because Olin unfairly delayed the freezeout to avoid paying the higher price. The Delaware Supreme Court reversed holding that the minority shareholders had alleged sufficient facts to support a claim of unfair dealing and that this required the Court of Chancery to closely focus upon *Weinberger's* mandate of entire fairness based on a careful analysis of both the fair price and fair dealing aspects of the transaction.⁵⁵⁸ On remand, Olin prevailed by convincing the court that the deci-

⁵⁵³ 380 A.2d 969 (Del. 1977).

⁵⁵⁴ 379 A.2d 1121 (Del. 1977).

⁵⁵⁵ 457 A.2d 701 (Del. 1983).

⁵⁵⁶ 498 A.2d 1099 (Del. 1985).

⁵⁵⁷ 2 ALI CORPORATE GOVERNANCE PROJECT, *supra* note 1, § 7.25 cmt. a, at 382.

⁵⁵⁸ *Hunt Chemical*, 498 A.2d at 1099.

sion to do the freezeout was not made until after the one year period had run.⁵⁵⁹

The Delaware Supreme Court's decision in *Kahn v. Lynch Communications Systems, Inc.*⁵⁶⁰ amplifies the application of the *Weinberger* principle. In *Kahn*, the court said: "Once again, this court holds that the exclusive standard of judicial review in examining the propriety of an interested cash-out merger transaction by a controlling or dominating shareholder is entire fairness. . . ."⁵⁶¹

The court then went on to say that although the controlling shareholder initially has the burden of establishing entire fairness,⁵⁶² if the transaction is approved by an "independent committee of directors or an informed majority of minority shareholders," the burden of proof on the fairness issue shifts to the shareholder-plaintiff.⁵⁶³ In this case, the court found that the "Court of Chancery's determination that the Independent Committee 'appropriately simulated a third-party transaction, where negotiations are conducted at arm's length and there is no compulsion to reach an agreement,' is not supported by the record."⁵⁶⁴ Consequently, the controlling shareholder had the burden of proof on the entire fairness question.

Some courts in other states continue to employ the business purpose test, as reflected in *Coggins v. New England Patriots Football Club, Inc.*⁵⁶⁵ In the *Patriots* case, the court pointed out that "[b]ecause the danger of abuse of fiduciary duty is especially great in a freezeout merger, the court must be satisfied that the freezeout was for the advancement of a legitimate corporate purpose."⁵⁶⁶ The court went on to say that the controlling shareholder has the "burden of proving, first, that the merger was for a legitimate corporate purpose and, second,

⁵⁵⁹ *Rabkin v. Olin Corp.*, 1990 WL 47648 (Del. Ch. 1990).

⁵⁶⁰ 638 A.2d 1110 (Del. 1994).

⁵⁶¹ *Id.* at 1117 (citing *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983)).

⁵⁶² *Id.*

⁵⁶³ *Id.*

⁵⁶⁴ *Id.* at 1121.

⁵⁶⁵ 492 N.E.2d 1112 (Mass. 1986).

⁵⁶⁶ *Id.* at 1118.

that, considering the totality of circumstances, it was fair to the minority."⁵⁶⁷

D. Application of the Delaware and ALI Freezeout Rules to the Time-Warner Transaction

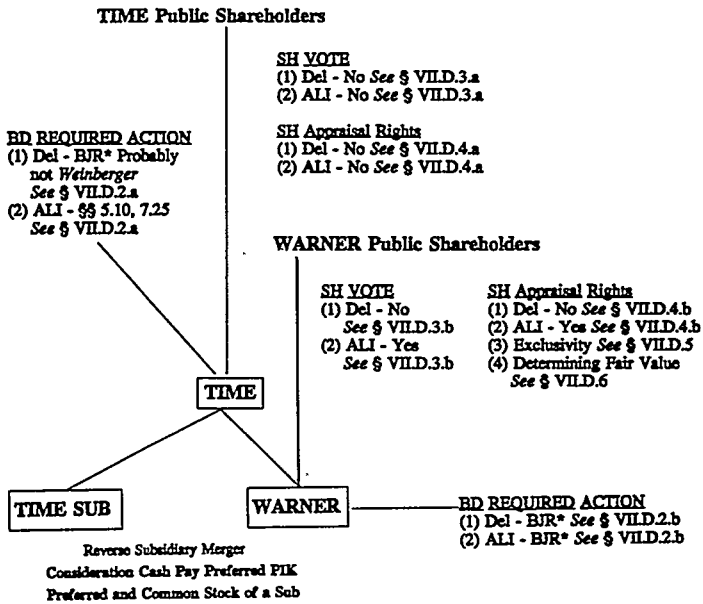
1. Description of the Freezeout Transaction

At this point, Time had completed its tender offer for Warner, and Time owned 60% of the Warner shares. The freezeout transaction was effectuated by a reverse subsidiary merger pursuant to which a subsidiary of Time, Time-Sub, merged into Warner. Pursuant to the freezeout merger the common shareholders of Warner received in exchange for their Warner shares a combination of Time cash pay preferred stock, Time PIK (payment in kind) preferred stock, and BHC common stock (i.e., common stock of a subsidiary of Time).⁵⁶⁸ The merger consideration was designed to have a value equal to the \$70 in cash per share paid in the tender offer. Upon completion of the transaction, Time, which had its name changed to Time-Warner, owned 100% of the common shares of Warner; the common shareholders of Time continued to own their common; and the minority common shareholders of Warner had their shares converted into cash pay and PIK Time preferred plus BHC common. The transaction can be diagrammed as follows:

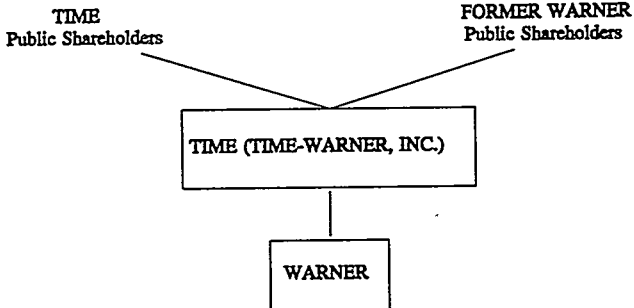
⁵⁶⁷ *Id.* at 1119.

⁵⁶⁸ Information Statement of Warner and Prospectus of Time Warner, Inc. (Dec. 6, 1989).

CHART C **FREEZEOUT MERGER FOR WARNER** **AFTER TIME'S TENDER OFFER** **FOR WARNER** *(See § VILD)*



WHEN DUST SETTLES



* BJR means business judgment rule

2. Required Actions and Standards Governing the Actions of the Boards of Directors

a. Time's Board

Time was not a constituent corporation under Section 251 of the Delaware General Corporation Law. Therefore, Time's directors acted pursuant to their general supervisory authority under Section 141.

Since Time was in control of Warner, it might appear that the freezeout transaction would be governed by the intrinsic fairness test set out in *Weinberger*.⁵⁶⁹ However, because the directors of Warner approved the transaction, the intrinsic fairness test in Delaware should not apply in this case, and Time's directors should receive protection under the business judgment rule.

Under Section 1.38 of the *Project*, the freezeout transaction would not have been a transaction in control with respect to Time, because there was no change in the ownership of Time's common stock. Therefore, Section 6.01(a), which deals with mergers, would not have been applicable to Time's board. Thus, at first instance, the actions of Time's board would have been governed by the duty of care standards in Section 4.01(a) and the business judgment rule of 4.01(c).

Since Time was in control of Warner, Section 5.10 of the *Project* would have applied and Time would have satisfied its duty of fair dealing to Warner and its shareholders provided either (1) the transaction was fair to Warner when entered into, or (2) the transaction was authorized by disinterested shareholders following disclosure concerning the conflict of interest in the transaction and the transaction did not constitute a waste of corporate assets. Thus, the fairness test would have applied if disinterested shareholders had not approved the transaction and a waste standard would have applied if disinterested shareholders had approved the transaction after full disclosure.

⁵⁶⁹ *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983).

Under Section 5.10(b), if the transaction is authorized in advance by disinterested directors or disinterested shareholders following disclosure, "the party challenging the transaction has the burden of proof."⁵⁷⁰ In this transaction, the freezeout was effectuated by Time voting its majority shares by consent rather than having a shareholders' meeting and conditioning the freezeout merger on the votes of disinterested shareholders. Consequently, it would appear that the fairness test of Section 5.10(a) would have applied. However, since the tender offer and freezeout were authorized in advance by the Warner directors, who were disinterested directors, the burden of proof would have been on the party challenging the transaction to prove that the transaction was not fair.

As indicated in Section VII.C.2.c, under Section 7.25 of the ALI rules, since this is a majority controlled freezeout, appraisal would have been the exclusive remedy, and consequently, the fairness test of Section 5.10(a)(1) would not apply provided, (1) the Time directors had "an adequate basis, grounded on substantial objective evidence, for believing that the consideration offered . . . constitute[d] fair value,"⁵⁷¹ (2) full disclosure concerning the transaction and conflict of interest was made, (3) the transaction was properly approved, and (4) the Warner shareholders had the right to dissent. Since the Warner directors approved the transaction, Time's directors should have satisfied the "adequate basis" condition and each of the other conditions should have been satisfied; consequently, the transaction should have come within Section 7.25.

b. Warner's Board

The business judgment rule applied to the decision of the Warner board to support Time's tender offer for Warner and the follow up freezeout merger. Since Warner was not the target of a competing offer, the *Unocal* enhanced business judgment rule was not applicable. Also, since the freezeout was ap-

⁵⁷⁰ 1 ALI CORPORATE GOVERNANCE PROJECT, *supra* note 1, § 5.10(b).

⁵⁷¹ *Id.* § 5.10(a)(1).

proved by the Warner board prior to the initiation of the tender offer, the intrinsic fairness test of *Weinberger* was not applicable.

Under the ALI rules, presumably the duty of care under Section 4.01(a) and the business judgment rule under Section 4.01(c) would have applied to the decision of the Warner directors to support the tender offer and the follow-up freezeout merger. This assumes that no directors or senior executive officers had an interest, within the meaning of Section 1.23 of the *Project*, in the transaction. If such an interest were present, the transaction would be subject to the management buyout rules of Section 5.15, and any such director or senior executive officer would have to prove that the transaction was fair unless the market test provisions of Section 5.15(b) had been satisfied.

The freezeout merger itself would have been a transaction in control under Section 1.38, and, consequently, Warner's board would have been subject to Section 6.01(a), which incorporates the duty of care of Section 4.01(a), and the business judgment rule of Section 4.01(c).

3. Right of Shareholders to Vote

a. Time's Shareholders

Because Time was not a constituent corporation under Section 251 of the Delaware General Corporation Law, Time's shareholders did not have a vote on the freezeout merger, unless a shareholder vote was needed to amend Time's charter to authorize the issuance of the cash payout and PIK preferred.

Since in the freezeout merger Time did not issue at least 25% of its common stock (it issued none), the freezeout would not have been a "transaction in control" with respect to Time under Section 1.38. Consequently, Time's shareholders would not have had a right to vote under Section 6.01(b).

b. Warner's Shareholders

Since Time owned more than 50% of the stock of Warner after the tender offer, Time effectuated the merger by voting its Warner shares pursuant to the consent provisions of Delaware law, thereby effectively denying the minority shareholders a vote on the transaction. Thus, no shareholder meeting was required to complete the merger.

Pursuant to Section 14(c) of the Securities Exchange Act of 1934,⁵⁷² Warner was obligated to distribute to its shareholders an information statement with respect to the freezeout merger. The information statement was required to contain information similar to that contained in a proxy statement under Section 14(a) of the Exchange Act, and the freezeout merger could not be implemented until 20 days after the date of distribution.⁵⁷³

Under the ALI rules, the freezeout merger would have been a transaction in control for Warner under Section 1.38. Consequently, the Warner shareholders would have had the right to vote under Section 6.01(b) of the *Project*.

4. Appraisal Rights in the Second Step Freezeout Transaction

a. Time's Shareholders

Since the shareholders of Time did not have a vote on the freezeout transaction, they did not have appraisal rights under Delaware law.

Under the ALI rules, the shareholders of Time would not have had appraisal rights because they satisfied the 40% continuity requirement of Section 7.21(a).

⁵⁷² 15 U.S.C. § 78n(c).

⁵⁷³ 15 U.S.C. § 78n(a).

b. Warner's Shareholders

Under Section 262 of the Delaware General Corporation Law, the common shareholders of Warner did not have appraisal rights in the second step freezeout merger because they received publicly traded stock in the transaction.

In the second step freezeout merger, the shareholders of Warner would have had appraisal rights under Section 7.21(a) of the *Project*, which applies to mergers and also under Section 7.21(b), which applies to freezeouts.

5. Exclusivity of Appraisal Proceedings for Warner's Shareholders in the Second Step Freezeout Transaction

As indicated in Section VII.D.4.b, in the second step freezeout transaction, the Warner common shareholders did not have appraisal rights under Delaware law because of the publicly traded shares exception in Section 262(b). Also, under the Delaware Supreme Court's decision in *Weinberger*, appraisal was the exclusive remedy in the absence of "fraud, misrepresentation, self-dealing, deliberate waste of corporate assets, or gross and palpable overreaching"⁵⁷⁴ Since the Warner directors had approved the second step freezeout, the transaction would appear to comply with the independent negotiating structure suggested in *Weinberger*.⁵⁷⁵

⁵⁷⁴ *Weinberger v. UOP, Inc.*, 457 A.2d 701, 714 (Del. 1983).

⁵⁷⁵ The Court said:

Although perfection is not possible, or expected, the result here could have been entirely different if UOP had appointed an independent negotiating committee of its outside directors to deal with Signal at arm's length. . . . Since fairness in this context can be equated to conduct by a theoretical, wholly independent, board of directors acting upon the matter before them, it is unfortunate that this course apparently was neither considered nor pursued. . . . Particularly in a parent-subsidiary context, a showing that the action taken was as though each of the contending parties had in fact exerted its bargaining power against the other at arm's length is strong evidence that the transaction meets the test of fairness.

Presumably the "entire fairness" test of *Weinberger* did not apply because the second step was approved as a result of arm's length bargaining by the Warner directors who were not interested in the transaction, acted in good faith, and were informed.⁵⁷⁶

As indicated above in Section VII.D.4.b, minority controlled freezeout transactions under Section 5.10 of the *Project* and majority controlled freezeouts under Section 7.25 of the *Project* do not give rise to exclusive appraisal rights under Section 7.24. However, Section 7.25 provides for exclusivity of appraisal rights in majority controlled freezeouts that satisfy the terms and conditions of that provision.

Under Section 7.25, an appraisal proceeding is the exclusive remedy for a majority controlled freezeout provided the following conditions are satisfied:

- (1) The directors who approved the transaction . . . have an adequate basis, grounded on substantial objective evidence, for believing that the consideration offered to the minority shareholders in the transaction constitutes fair value for their shares . . . ;
- (2) Disclosure concerning the transaction . . . and [the directors' beliefs with respect to value and the conflict of interest] is made to the minority shareholders . . . ;
- (3) The transaction is [properly and legally] approved . . . ; and
- (4) [The shareholders have a right to appraisal].⁵⁷⁷

Thus, if the above four elements are satisfied, appraisal is the exclusive remedy. Also, the challenging party has the burden of proving the failure to satisfy the above requirements.

In this situation, since Time owned approximately 60% of the stock of Warner, the freezeout transaction was a majority controlled freezeout and, therefore, would have been subject to the

Id. at 709-10 n.7.

⁵⁷⁶ See, e.g., *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1134 (Del. Ch. 1994).

⁵⁷⁷ 2 ALI CORPORATE GOVERNANCE PROJECT, *supra* note 1, § 7.25(a).

exclusivity rules of Section 7.25 of the *Project*, which appear to have been satisfied.

6. Determining Fair Value of Shares in Appraisal Proceeding in the Second Step Freezeout Transaction

As indicated above, under Delaware law appraisal is the exclusive remedy in the absence of fraud, misrepresentation, self dealing and the like, under the *Weinberger* standard. Also, modern valuation techniques would be used in determining the value of the dissenters' shares.

Fair value under the ALI rules would be determined under Section 7.22(c). This provision provides that in any majority controlled or minority controlled freezeout under Section 5.10 or 7.25 the "court generally should give substantial weight to the highest realistic price that a willing, able and fully informed buyer would pay for the corporation as an entirety."⁵⁷⁸ This provision also provides that in making this determination the court may include "a proportionate share of any gain reasonably to be expected to result from the combination, unless special circumstances would make such an allocation unreasonable."⁵⁷⁹

In the case of two-tiered tender offers, the *Project* says that "[a]bsent material adverse changes to the corporation or a general market decline, the front-end purchase price would . . . normally constitute a floor."⁵⁸⁰ Thus, in the two step tender offer where the second step follows the first step shortly after completion of the first step, the price offered in the first step should be determinative of the fair market value of the shares in an appraisal proceeding resulting from the second step freezeout.

In this case this would mean that the value of the Warner shares cashed out in the freezeout merger would be no less than the \$70.00 purchase price paid by Time in the first step.

⁵⁷⁸ *Id.* § 7.22(c).

⁵⁷⁹ *Id.*

⁵⁸⁰ *Id.* § 7.22 cmt. f, at 328-29.

This floor rule does not apply, however, if the first step sale was a private purchase of the controlled shares at a premium in a transaction that would otherwise be covered by Section 5.16.⁵⁸¹

If there is a two tier tender offer for 100% of the target shares in an "any and all" tender offer, and the disinterested directors of the target accept the tender offer price as fair, the acceptance of the price by such directors should be seen as the functional equivalent of its approval by an arm's length merger with the same acquiror.⁵⁸² Consequently, the tender offer price paid by Time should be found to be the fair value of the Warner shares in an appraisal proceeding relating to the freezeout merger. This rule could force acquirors to pay the same price in a second-step freezeout that they pay in the first-step tender offer.

E. Observations

The exclusivity of the appraisal proceeding in Section 7.25 should be available in most majority-control freezeouts in which the waste test of Section 5.10 otherwise would apply. As illustrated in Table 1, the waste standard applies and the burden is on the challenging party if (1) full disclosure of the conflict of interest and the transaction is made, and (2) disinterested shareholders approve the transaction. There is no requirement that disinterested directors approve the transaction.

Majority control freezeouts will be subject to the exclusivity provisions of Section 7.25 if the following three basic conditions are satisfied. First, the directors who approve the transaction have "an adequate basis, grounded on substantial objective evidence for believing that the consideration offered to the minority shareholders in the transaction constitutes fair value for their shares"⁵⁸³ Second, the transaction complies

⁵⁸¹ *Id.* at 329.

⁵⁸² *Id.*

⁵⁸³ *Id.* § 7.25(a)(1).

with all the relevant legal requirements.⁵⁸⁴ Third, dissenting shareholders have appraisal rights.⁵⁸⁵ The second and third requirements will be satisfied in virtually every case, and if disinterested directors are utilized, the first condition should be satisfied. Thus, as a practical matter, in every majority controlled freezeout in which the transaction is approved by both disinterested directors and disinterested shareholders, appraisal will be the exclusive remedy. Consequently, the transaction cannot be challenged under even a waste standard. Further, dissenting shareholders rarely would be successful in an appraisal proceeding.

If the waste standard in Section 5.10 applies to a non-majority control freezeout, appraisal is not the exclusive remedy because Section 7.25 is not applicable. As a practical matter, however, it would be highly unlikely that challenging shareholders could establish that the transaction was a waste of assets. And, where the waste standard applies, it would also be unlikely that dissenting shareholders would be successful in an appraisal proceeding.

On the other hand, evidence that a target's senior executives received long-term compensation agreements from a successful but low bidder but tilted a transaction to a low bidding white knight with whom they had a prior relationship could constitute "clear and convincing evidence sufficient to overcome the presumption [of fair value] created by Section 7.22(b)."⁵⁸⁶ Also, the *Project* points out that this type of compensation package could cause the senior executives to be deemed "interested" in the transaction which would trigger scrutiny under the Section 5.15 management buyout provision.⁵⁸⁷

⁵⁸⁴ *Id.* § 7.25(a)(3).

⁵⁸⁵ *Id.* § 7.25(a)(4).

⁵⁸⁶ *Id.* § 7.22 cmt. c, illus. 2, at 318.

⁵⁸⁷ *Id.* See *supra* Part IV.

VIII. CONCLUSION

The *ALI Corporate Governance Project* provides suggested governance rules for all forms of mergers and acquisitions, including arm's length business combinations, management buyouts, tender offers, sales of controlling stock interests, and freezeouts. Each of these governance rules is illustrated in this article by reference to the three-steps of the 1989 acquisition by Time, Inc. of Warner Communications, Inc.

For arm's length mergers and acquisitions, the *Project*, in essence, suggests the adoption of a *de facto* merger principle for determining shareholders' voting and appraisal rights.⁵⁸⁸ Under this principle, the shareholders of both the acquiring and target corporations have the same rights to vote and dissent without respect to the form of the transaction. Also, for arm's length transactions, the *Project* suggests that the board of directors be subject to the standard business judgment rule.⁵⁸⁹

For management buyouts, the *Project* suggests that unless the transaction is fully disclosed and market tested, the interested director/executive should have the burden of establishing that the transaction is fair to the target's shareholders.⁵⁹⁰

The *Project* suggests that the defensive tactics taken by a target's board be examined under a special reasonableness test, with the burden of proof on the challenging party.⁵⁹¹ This test is similar to the enhanced business judgment rule under the Delaware Supreme Court's decision in *Unocal* except the burden is not on the target's directors.

The rules proposed by the *Project* for the sale of controlling stock interests are substantially similar to the rules of current law. Consequently, under the *Project's* rules, controlling shareholders need not share a control premium with other sharehold-

⁵⁸⁸ See *supra* Part III.

⁵⁸⁹ See *supra* Part II.

⁵⁹⁰ See *supra* Part IV.

⁵⁹¹ See *supra* Part V.

ers; however, the controlling shareholder must take care not to sell to a known looter.⁵⁹²

Finally, the *Project* suggests a different set of rules for majority control and non-majority control freezeouts.⁵⁹³ Appraisal is not the exclusive remedy for non-majority control freezeouts, but is available for majority control freezeouts that meet certain standards regarding disclosure and an independent bargaining structure.

⁵⁹² See *supra* Part VI.

⁵⁹³ See *supra* Part VII.